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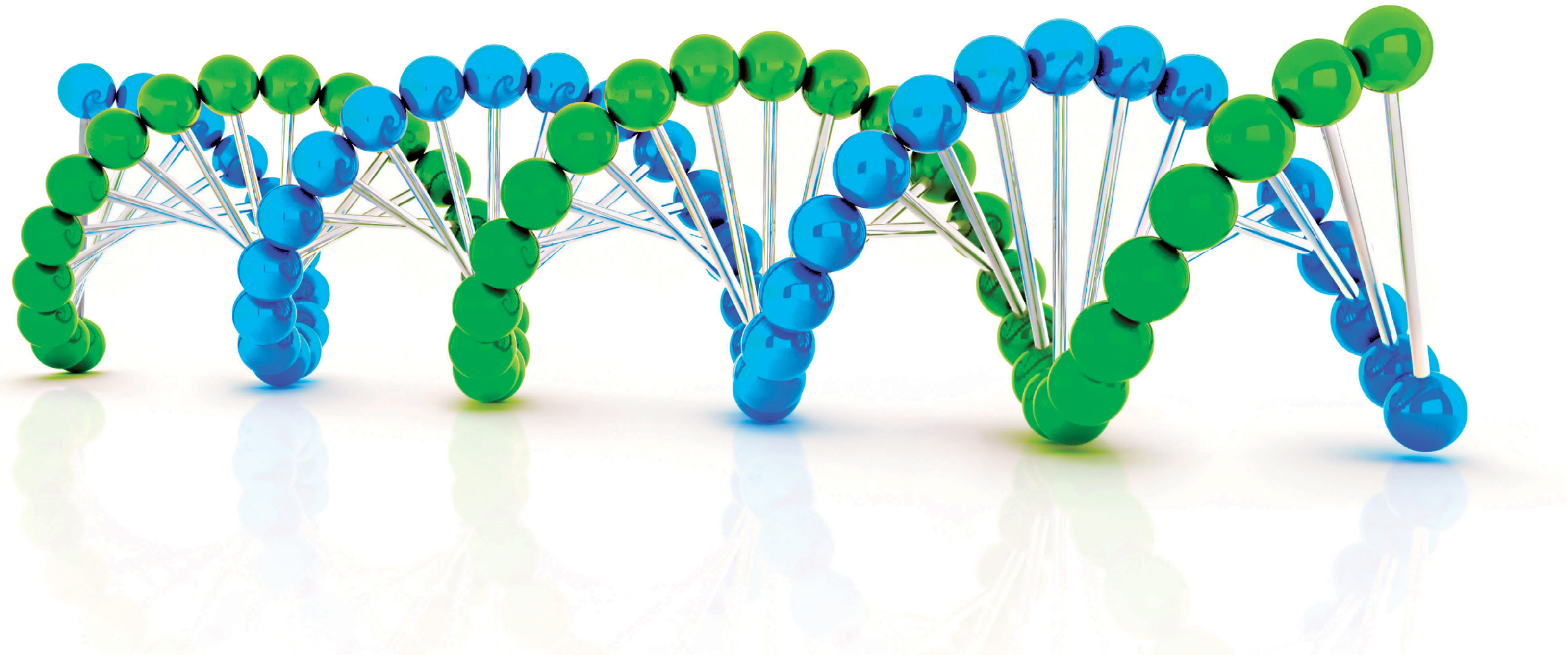
Progress post Walker

The evolution of Board Audit and Risk Committees in financial services



Introduction

The financial crisis highlighted imbalances between the increasing growth and complexity of the financial services industry and fundamental failures in governance and risk management, raising important questions and calling for changes across the market.

A key response to these challenges was Sir David Walker's *'A review of corporate governance in UK banks and other financial entities'* (the Walker Report) published in 2009, which recommended, amongst other items, the establishment of a separate Board Risk Committee (BRC) as a means of addressing the overload of Non-Executive Directors (NEDs) on Audit Committees (AC) and the need for a closely-related but separate capability to focus on risk in future strategy.

Over four years on from the Walker Report, this analysis looks at how firms are responding to the challenges and fulfilling the increased expectations, with particular focus on the AC versus the BRC. We present our findings from a data-driven exercise, looking at publicly disclosed information published in 2012 from 25 listed banks and other financial institutions (BOFIs).

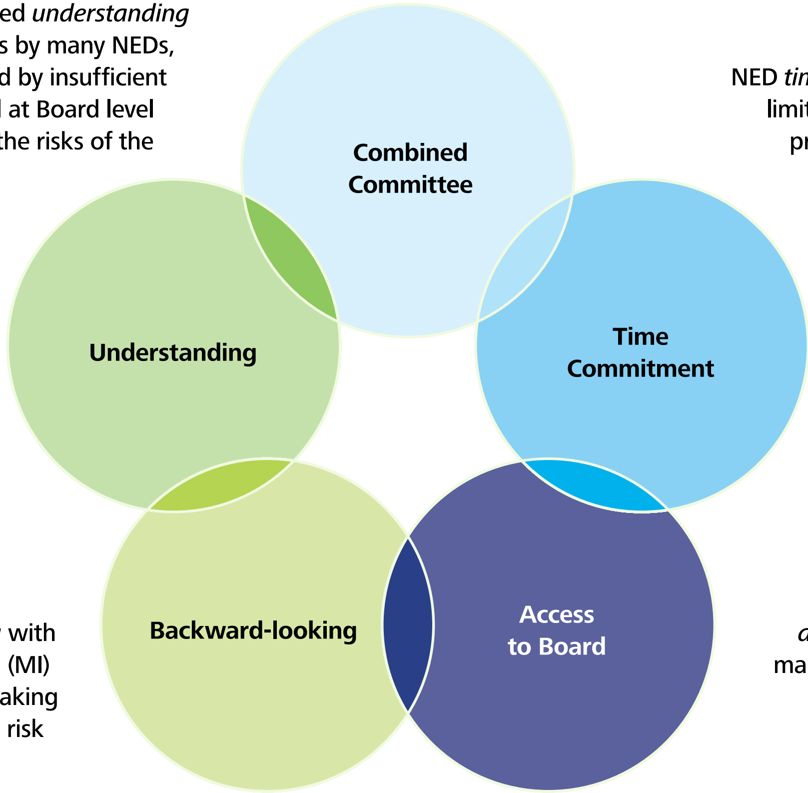
Pre-crisis state of play

Lack of focus on risk management at Board sub-committee level

Combined Audit & Risk Committee was the norm

There was a lack of detailed *understanding* of all areas of the business by many NEDs, in some cases exacerbated by insufficient breadth and depth of skill at Board level to effectively manage all the risks of the business

NED *time commitment* was often limited to Committee meeting pre-reading and attendance



Audit & Risk activity was largely *backward-looking* with management information (MI) often poorly presented making effective forward-looking risk management challenging

There was a poor level of *access to the Board* for risk management functions and a lack of clarity around reporting lines

Drivers for change post-crisis

Underlying the structural recommendations from Walker, there was a need for:

Improved Board risk oversight, with clearer risk ownership and a more direct relationship between senior risk management and the appropriate Board committees.

More diversity in the skill set and experience, and an increase in time commitment from NEDs to meet their responsibilities.

Material behavioural changes across the business, with enhanced risk consciousness and culture to be embedded throughout an organisation.

A much stronger focus on the risk consequences of remuneration.

A more forward-looking focus on risk management.

Emerging role of the Board Risk Committee post-crisis

Separate Board Risk Committees and Audit Committees are now the norm

The split of responsibilities between the two committees is increasingly well defined.

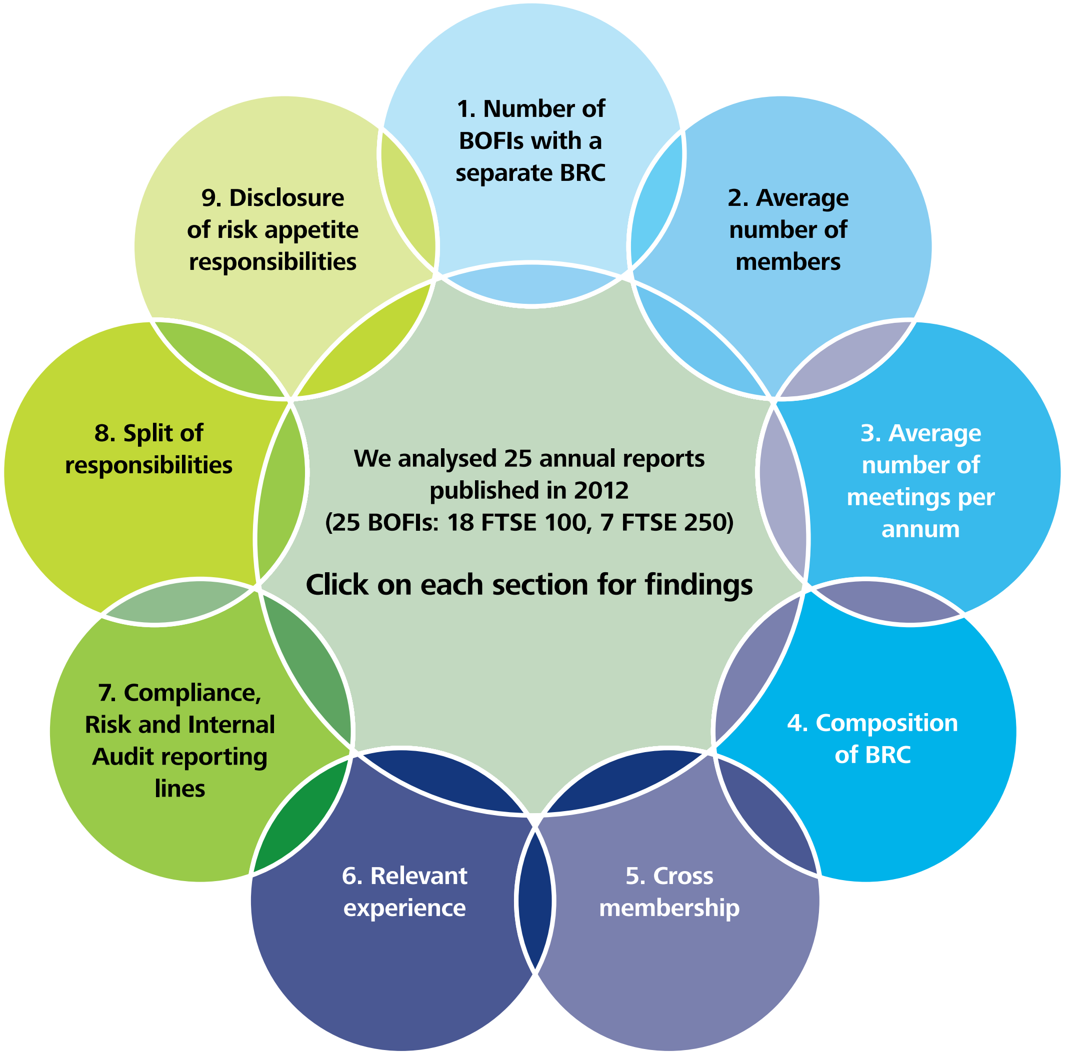
Nearly all ACs oversee Internal Audit (IA) and most BRCs oversee risk management functions.

We are seeing a number of practical steps being taken to ensure the alignment of both Committees and reduce the risk of gaps or overlap:

- Cross membership is normal practice;
- Meeting synchronisation or joint meetings;
- Agenda agreement and delineation; and
- Minute and report sharing.

Current state of play

Structural developments since 2009



Identified areas for continued focus

BOFIs have responded strongly since 2009, but challenges remain

Strengthening the risk and compliance experience of BRC members.

Equipping BRCs with good quality, concise management information that highlights the key assumptions, sensitivities and big bets; rather than volumes of data.

Ensuring NEDs remain independent and don't stray into a quasi-management role as their involvement grows.

Embedding risk appetite throughout the organisation.

Greater prominence of compliance at Board sub-committee level.

The need for real and lasting change in the risk culture of the institution, with increasing emphasis on the significance of conduct risk.

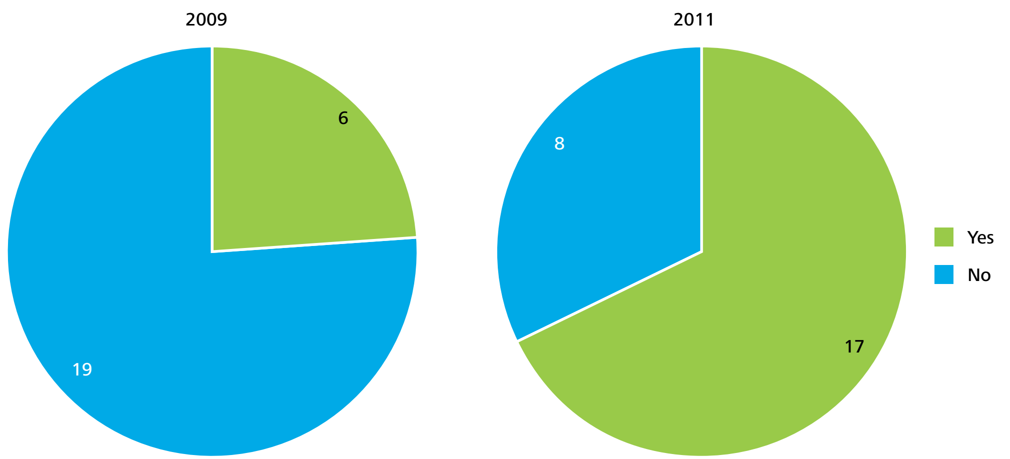
Analysis

1. Number of BOFIs with a separate BRC

9 1 2 8 Click for analysis 3 7 4 6 5

When comparing the number of banks with separate BRCs in 2009 to 2011 we identified:

- BRCs are now the norm.
- 17 out of 25 had separate BRCs in 2011, of which six already had BRCs prior to the Walker Report.
- Of the eight BOFIs that retained a combined Audit and Risk Committee there were several Asset Managers reflecting a more intensive focus on enhancing governance in banks and perhaps also the narrower range of financial risks material to asset managers versus banks and insurers.



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Analysis

2. Average number of members

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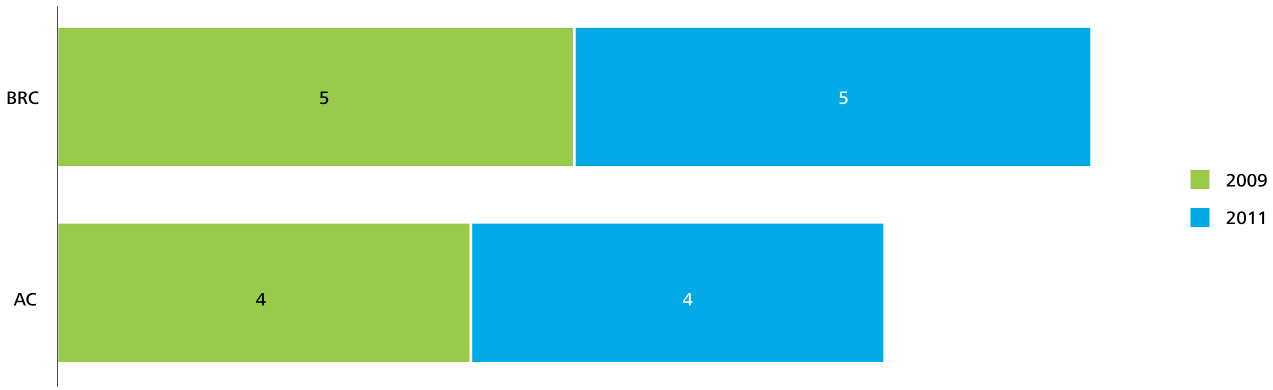
Click for analysis

We analysed the average number of members on each of the two committees in 2009 versus 2011 and observed the following:

- The slightly higher number of members on BRCs compared to ACs is likely attributable to organisations wanting to bring a breadth of skills to the BRC as well as ensuring overlap with the AC and Remuneration Committee.



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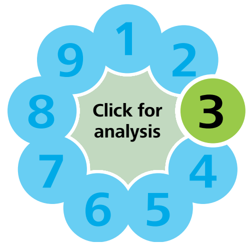
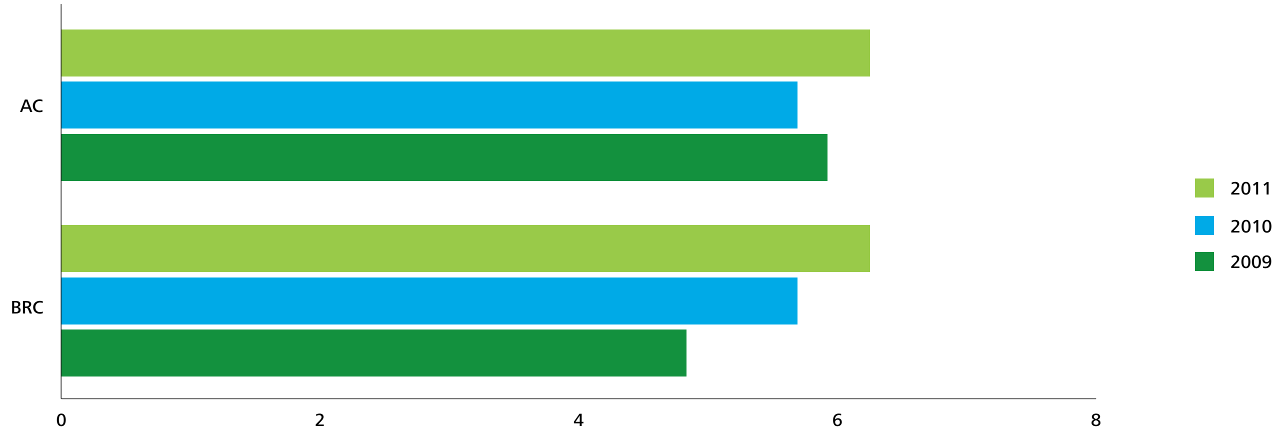
Analysis

3. Average number of meetings per annum



We analysed the average number of meetings from 2009 to 2011 and observed the following:

- Whilst both committees met on average six times in 2011, the average number of BRC meetings has steadily risen since 2009 reflecting the changing environment and need for additional discussion.



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Analysis

4. Composition of BRC

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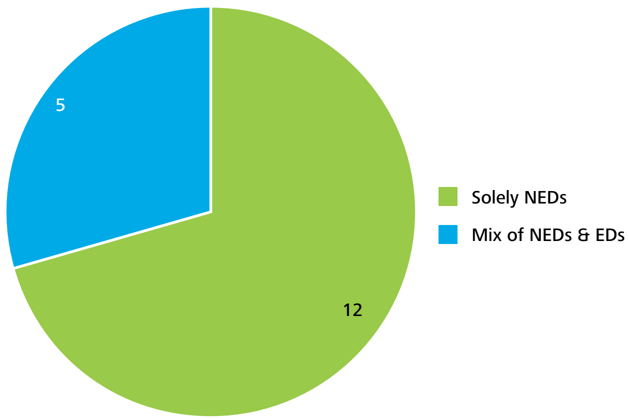
We analysed the composition of BRCs in terms of Non-Executive and Executive membership and observed the following:

- BRCs occasionally have a mix of NEDs and Executive Directors (EDs).
- Whilst the majority of BRCs are composed of solely NEDs, five firms, including three insurers, have a mixed committee composition.
- The EDs tend to be Chief Financial Officers and on occasion, Chief Executives or Chief Operating Officers.
- The mixed composition potentially reflects the depth of knowledge and skills deemed by some boards to be necessary effectively to define and embed risk appetite and a risk intelligent culture whilst still demonstrating an external, independent challenge.



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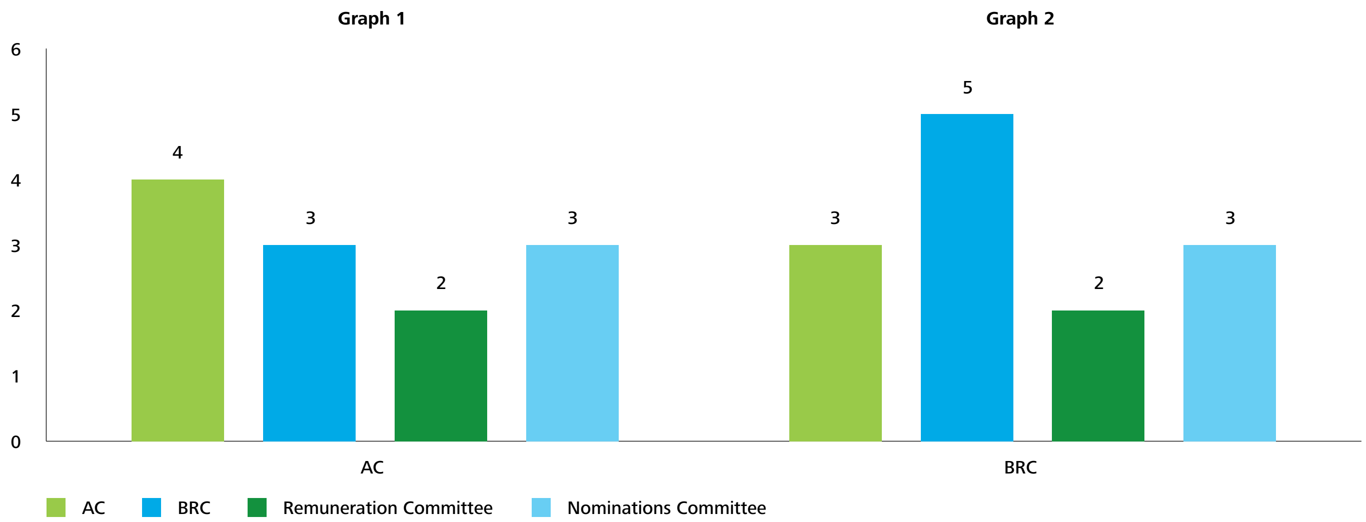
Analysis

5. Cross membership

1 2 3 4 5 6 7 8 9 Click for analysis

Graph 1 shows the number of members on the AC and of these individuals, how many are also members of other Board Committees. Graph 2 shows the number of members on the BRC and of these, how many individuals also sit on other Board Committees. We observed the following:

- There is a high reliance on cross-membership between AC and BRC members, with three members on average sitting on both committees.
- All 17 firms with separate BRCs have AC and BRC Chairs sitting on the other committee.



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Analysis

6. Relevant experience

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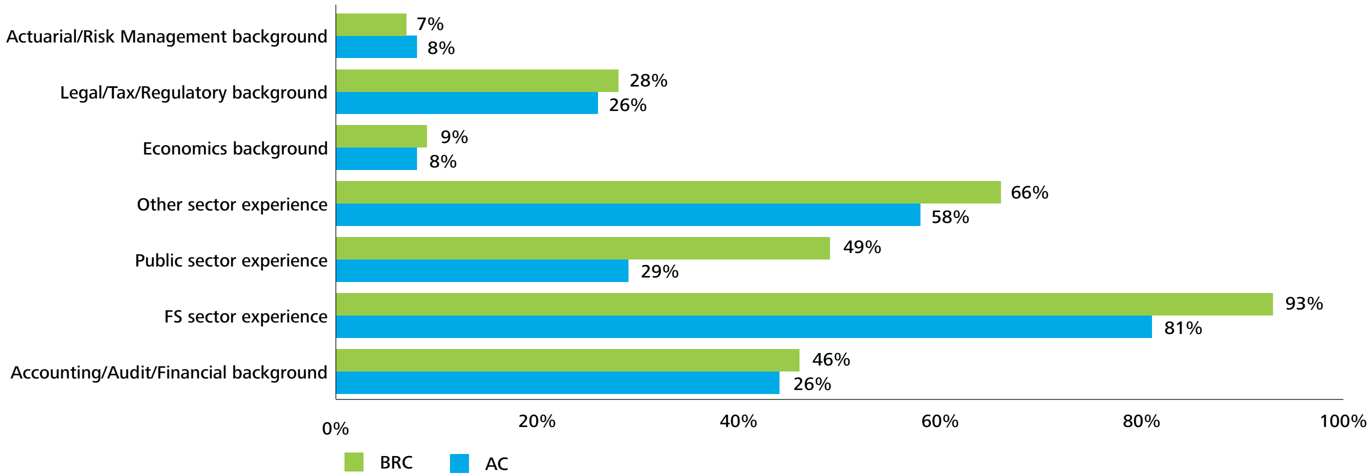
The below graph shows the percentage of each committee with relevant experience in 2011:

- There is limited in-depth risk and compliance experience (for example, to the extent of a former Chief Risk Officer (CRO) or Head of Compliance (HoC)).
- We would expect to see more specific and direct risk experience to start to emerge on Boards and in BRCs in time as in our view, it is likely that some CROs and HoCs may start to migrate into NED roles over the next three to five years as they retire from their executive roles.



As interpreted from the biographies available in the 2011 Annual Report

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Analysis

7. Compliance, Risk and Internal Audit Reporting lines

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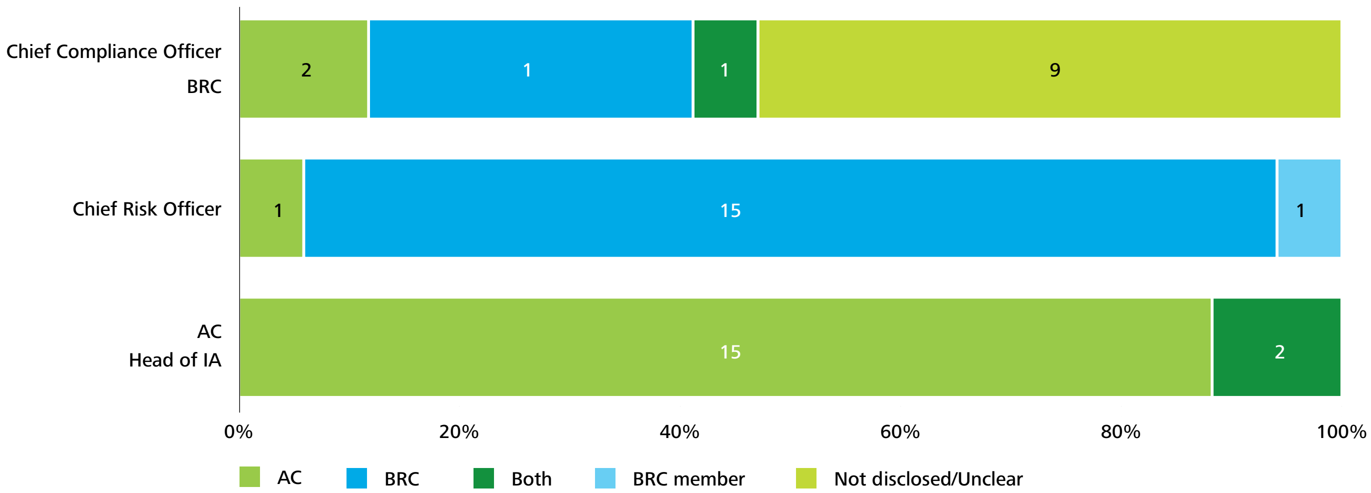
We analysed the reporting lines of Heads of Control Functions into the BRC and AC in 2011 and observed the following:

- Nearly all ACs oversee Internal Audit (IA) and most BRCs oversee risk management functions.
- Oversight of compliance is mixed/unclear.
- There are instances where Heads of Internal Audit (HIA) report to both committees.
- Our research also shows a large proportion of CROs and HIAs attending both committee meetings, as opposed to having hard reporting lines. However, BRCs appear to have a more 'open door' policy.
- These findings are interesting in light of the recent consultation document by the Chartered Institute of Internal Auditors *'Effective Internal Audit in the Financial Services Sector'* which recommended, amongst other things, that Internal Audit should be present at both the AC and the BRC, and should have a primary reporting line to the Chairman of the AC.



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Analysis

8. Split of responsibilities

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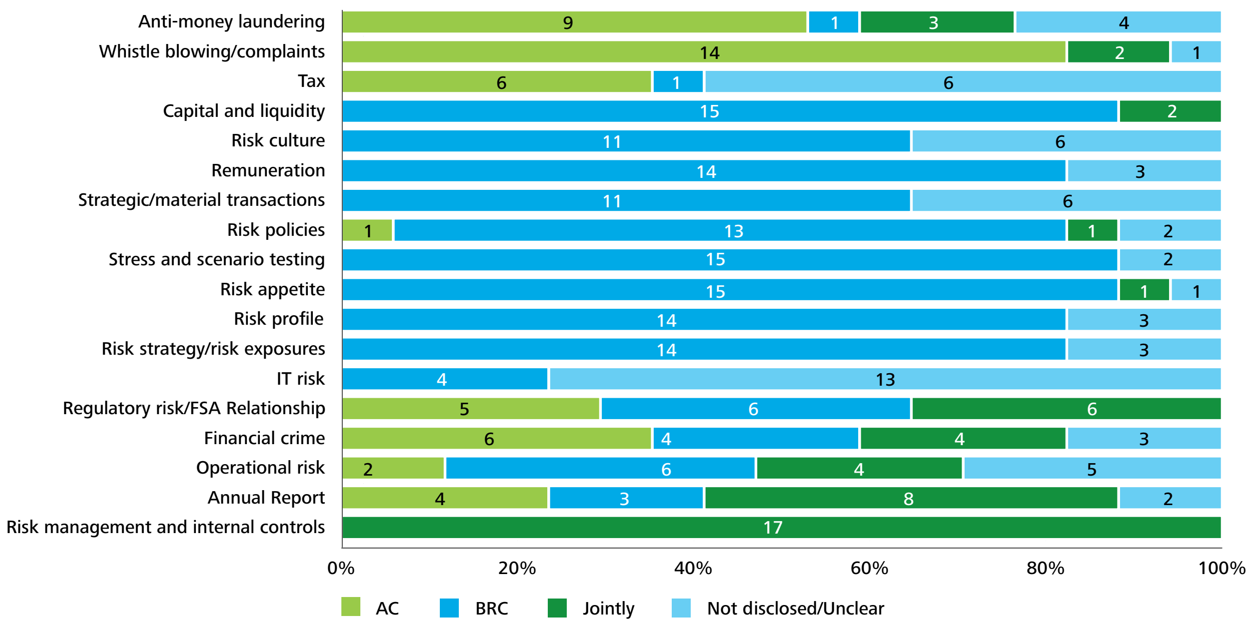
The below graph shows the percentage of each committee with relevant experience in 2011:

- A number of responsibilities have moved to BRCs which previously sat with the AC, and with mixed practice observed for oversight of key regulatory risks and operational risk.
- Oversight of risk management and internal controls (and associated disclosures in the annual report) is jointly conducted, reflecting the overlapping interests of the two committees.



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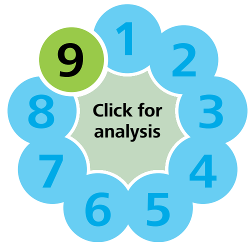
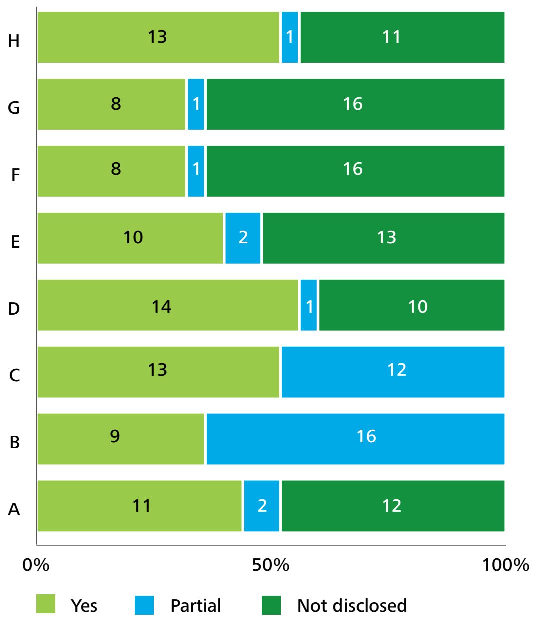
Analysis

9. BOFIs disclosing risk appetite responsibilities



The below graph shows whether and the extent to which BOFIs are disclosing risk appetite responsibilities in 2011. We observed the following:

- There is room for enhancement of risk disclosure with many not externally evidencing that they meet Walker's requirements on risk appetite.



Key references in the 2009 Walker Report:

A. **Paragraph 6.13:** "Advise the board on risk appetite and tolerance for future strategy".

B. **Recommendation 23:** "Take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments".

C. **Paragraph 6.13:** "Qualitative and quantitative advice to the remuneration committee on risk weightings to be applied to performance objectives incorporated within the incentive structure for the CEO and executive team".

D. **Paragraph 6.9:** "View on capital and its prospective adequacy over the cycle in the light of the entity's overall strategy and the external risk environment".

E. **Paragraph 6.14:** "The risk assessment process should involve some quantitative metrics to serve as a way of tracking risk management performance in implementation of the agreed strategy".

F. **Paragraph 6.14:** "Review and approval of the parameters used in these measures and the methodology adopted".

G. **Paragraph 6.14:** "Setting of a standard for the capability to monitor, in a sufficiently accurate and timely manner, particular large exposures whose relevance, possibly because of some external shock, may become of critical importance".

H. **Recommendation 26:** "In respect of a proposed strategic transaction involving acquisition or disposal, it 'should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate 'and available, before the board takes a decision whether to proceed".

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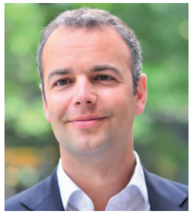

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