Bank Governance Leadership Network
ViewPoints
March 26, 2012
TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

Improving risk identification

As discussed in "Progress on the risk governance journey, but key challenges remain,"[1] despite significant investment in improvements to risk management and oversight, some executives, directors, and supervisors still question their ability – as individual institutions and as an industry – to identify and react quickly to top and emerging risks. While some fear that trying to gauge readiness for ambiguously defined "emerging risks" may trap banks in a unending series of stress tests and scenario planning, most agree that gaining broader perspectives on plausible, even if remote, risks that could have a significant systemic impact would be highly beneficial.

In that context, Bank Governance Leadership Network (BGLN) meetings were held on February 15 in New York and February 29 in London to discuss top and emerging risks. Michael Alix (senior vice president, Federal Reserve Bank of New York), Michael Brosnan (senior deputy comptroller, Office of the Comptroller of the Currency), and Ted Price (deputy superintendent, Office of the Superintendent of Financial Institutions) attended the New York meeting. Lyndon Nelson (director, Risk Management Division, Financial Services Authority) attended the London meeting. In aggregate, six non-executive directors and eight chief risk officers from 12 global banks attended these meetings.

At the meetings, participants discussed the risks they view as most worrisome, including the potential impact of the eurozone crisis, regulatory change, and evolving geopolitical risks.[2] This *ViewPoints* synthesizes the perspectives and ideas from the meetings – and from nearly 50 discussions before the meetings with directors, executives, supervisors, and banking professionals – on how best to improve banks' ability to identify and evaluate top and emerging risks:[3]

- Banks should foster a culture that identifies and talks openly about potential risks
- Transparency regarding the interconnectedness of the system should be improved
- Regulators and supervisors should share their insights on emerging risks

Banks should foster a culture that identifies and talks openly about potential risks

Near-term priorities often crowd out forward-looking risk identification when it comes to allocation of banks' time and resources. However, network participants identified a number of practical ways banks can improve how they identify and evaluate top and emerging risks:

- **Explicitly allocate time to discuss emerging risks.** Time and resources are often focused on reviewing risk data, compliance, and regulatory reporting activities. A CRO asked, "*How forward looking can we be when we are consumed with rearview-mirror reporting?*" Overburdened executive

---

[1] Bank Governance Leadership Network, "Progress on the risk governance journey, but key challenges remain," *ViewPoints*, January 12, 2012.

[2] Bank Governance Leadership Network, "Top or emerging risks facing global banks," *ViewPoints*, March 26, 2012 and Bank Governance Leadership Network, "Implications of the eurozone crisis," *ViewPoints*, March 26, 2012.

[3] All discussions were held under a modified version of the Chatham House Rule that encourages sharing of perspectives but absolutely forbids attribution to individuals or institutions. All comments from participants are italicized. A complete list of participants can be found in Appendix 1, on page 6. A complete list of interviewees can be found in Appendix 2, on page 7.

and board risk committees are left with limited time to focus on emerging risks and limited insight into the way other institutions are thinking about these risks and the potential exposures. One director said, *"I worry about what's getting squeezed off the agenda."* To address the problem, one CRO proposed that risk committees *"set aside time in every risk committee meeting to have blue-sky thinking."* Participants said supervisors could help encourage boards and risk committees to focus on forward-looking risk identification by clarifying expectations of non-executive directors and by limiting the volume of compliance items and approvals that they insist on elevating to the director level.

- **Expect more from the non-executive directors.** Prior to the meeting, one CRO said, *"90–95% [of the information flow] to boards and even regulators is one-way from management."* This need not be the case, however. Directors could bring more to the discussions, particularly because they "sit on other boards and can bring different perspectives." At the meeting, one CRO said, "*To date, the non-executive directors have not come up with something we haven't thought out. Hopefully, that will change."* Another CRO said, *"There is a difference between who provides the data, i.e., management, and who can start the dialogue, i.e., the board. Directors can make valuable observations and bring different perspectives."*

- **Encourage employees to be creative and communicative.** Several participants warned against relying on risk and business leaders to identify risks. A CRO said, *"There is no computer that can churn out a list of emerging risks. We have a lot of people, [and they] have a lot of ideas. So we are working on ways to get them to communicate their concerns or ideas to [the risk function]. They may have an idea that we haven't thought about."* Another CRO noted that risk officers may focus on the wrong things or miss something small, and others can help highlight *"the risk tomorrow of today's bright ideas."*

- **Ignore probabilities and focus on potential impact.** Few executives or boards have an appetite for unbounded discussions of "what-if" scenarios. One director asserted before the meetings, *"Trying to identify black swans is useless."* Another director said, *"You can have 14 risks on your list, and it's the 15th that kills us."* Problems often arise, however, not from complete unknowns but from risks that are recognized, but perceived as having a very low likelihood or not much potential impact. Many people warned of the risks of the real-estate asset bubble, subprime mortgages, and syndication prior to the crisis, but few heeded them.

  At the meetings, one CRO made the case for investing in understanding the implications of even low-probability risks: "*Boards are still talking too much about probabilities. We prefer to take a risk, run the stress test, [and] identify the amount of potential impact so we are all comfortable with that level of risk."* Another CRO noted the broader value that playing out any given scenario, regardless of probability, can have: *"The lessons we learn about how to deal with the* scenario *– thinking about the implications, the role play, the rehearsal – are very helpful."*

- **Focus on second- and third-order effects.** A CRO noted before the meetings, *"We are not in the business of trying to look around corners – but what is the range of risks you need to understand are possible, and the possible outcomes?"* For example, one CRO noted the impact that unforeseeable events such as the 2011 tsunami in Japan can have on the economy and banking sector: *"The tsunami is now old news, but the impacts on supply chains are still with us."* Another CRO agreed, noting that *"one of our lessons of the past few years is that we are pushing our thinking harder and harder on the second- and third-order issues."* A supervisor said, *"The trigger events are almost irrelevant. It's the transmission mechanism that's most important."* Indeed, bank responses to events can precipitate second-order effects: one CRO asked, *"When do we decide to ask for more collateral from a counterparty? The minute we do, it has follow-on effects."*

- **Ensure risk information is usable.** A supervisor noted before the meetings that when risk committees are overwhelmed by data, it is hard to distinguish the usable from the unusable information: *"Turning data into real information is where risk committees often break down."* Another supervisor asked, *"What different kinds of information should folks be using to assess risk?"*

Transparency regarding the interconnectedness of the system should be improved

The financial crisis revealed the opacity of the financial system and the failure of actors on the financial sector to recognize the interconnectedness of global institutions and those institutions' risk exposures. The risk of the contagion effect on the system due to a lack of transparency remains a major concern. Prior to the meeting, a regulator said, *"Interdependence is far too high."* Another observed that as a result, *"if the market doesn't think [an event] is idiosyncratic, it's not."* At a meeting, one CRO said, *"Interconnectivity and the lack of transparency around that in the system [is a real risk] … There is very fragile confidence in the system … I worry about a small incident triggering a large event in the market, a chain reaction."*

One supervisor noted, *"The practical problem is [that] reacting to the current problem with [voluntary] disclosures looks defensive."* A prime example is the pressure put on banks last fall to disclose their eurozone exposures, particularly to peripheral countries. One CRO remarked, *"It was an interesting exercise, but with no standards, it became an exercise to provide not too much and not too little."*

One CRO said that better disclosures would help. Another asked, *"What is the meaningful set of two to three numbers that would help banks understand what is going on?"* Participants agreed with a supervisor who concluded, *"Data standardization would be really helpful."* Indeed, one CRO asserted that *"70% to 80% of the data requests [from supervisors] can be collapsed into a standard template."* Supervisors, standards setters, and banks would find gaining agreement on new standardized disclosures or reporting requirements challenging: efforts of this sort have failed in the past. However, as one director said, *"This is a legitimate global project,"* and, as a CRO noted, *"There would be a huge incentive for us to get this right."*

Regulators and supervisors should share their insights on emerging risks

Many central banks and other international organizations, such as the International Monetary Fund and the Financial Stability Board, publish lists of risks. Unfortunately, many bank executives and directors said the lists tend to be of limited value because in an effort to reach consensus within the authoring institution or institutions, the risks are often too high level, and by the time the lists are published, many of the risks have become obvious.

Bank participants would like supervisors to share their unpublished lists of top or emerging risks, because they know supervisors have a unique cross-institution perspective. While these lists may not have gone through formal vetting processes, they are often much more specific or novel in nature, and thus more helpful. However, at present, this knowledge sharing doesn't happen often. One CRO complained, *"The regulators talk to me about my top and emerging risks, but do not share their own."*

Supervisors may be concerned that they will be criticized in the future for not including a risk on their lists that ends up causing systemic problems. They may also worry that in some instances the very act of identifying new risks can be self-fulfilling. A real example, the potential for Scottish independence, was discussed at one meeting (the UK and Scottish governments have agreed to hold a referendum in 2014). Asked one meeting participant:

> Now that it is a potential, when should the authorities flag [that] this may have consequences for customers of Scottish firms, or [for] firms operating with Scottish firms? When should they insist on disclosures on the potential impact, e.g., for those investing in Scottish pensions? When will they signpost they will require actions on the potential impact?

Participants acknowledged that the moment the authorities act, it will have ramifications. Notwithstanding these concerns, many supervisors agree with one of their peers who suggested that they should find more ways to discuss their views on a firm-by-firm basis because, ultimately, *"we are interested in the financial-stability level; we are worried about the industry-wide blind spots."*

⋆ ⋆ ⋆

Banks' and supervisors' abilities to identify and evaluate top and emerging risks and their effects remains constrained. To make any real progress on the risk front, all key constituents – directors, CROs, supervisors, and standards setters – must be willing to work together, support risk-aware cultures at financial institutions, and promote transparency.

About this document

The Bank Governance Leadership Network (BGLN) addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy banking institutions.

The BGLN is organized and led by Tapestry Networks with the active support and engagement of Ernst & Young as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead. Ernst & Young is a global leader in assurance, tax, transaction, and advisory services to the banking industry.

ViewPoints aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Anyone who receives *ViewPoints* is encouraged to share it with those in their own network. The more board members, members of senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

Appendix 1: Meeting attendees

February 15 meeting attendees

- Michael Alix, Senior Vice President, Federal Reserve Bank of New York
- Michael Brosnan, Senior Deputy Comptroller, Office of the Comptroller of Currency
- Morten Friis, Chief Risk Officer, RBC
- Keishi Hotsuki, Chief Risk Officer, Morgan Stanley
- Karen Maidment, Director, TD Bank
- F. Edward Price, Deputy Superintendent, Office of the Superintendent of Financial Institutions
- Catherine Rein, Audit Committee Chair, BNY Mellon
- Brian Rogan, Chief Risk Officer, BNY Mellon
- Anthony Santomero, Risk Management and Finance Committee Chair, Citigroup

February 29 meeting attendees

- Nathan Bostock, Head of Restructuring and Risk, RBS
- Juan Colombás, Chief Risk Officer, Lloyds Banking Group
- Sir Howard Davies, Risk Committee Chair, Morgan Stanley
- Karl Guha, Chief Risk Officer, UniCredit
- Marc Moses, Chief Risk Officer, HSBC
- Lyndon Nelson, Director, Risk Management Division, Financial Services Authority
- Benoît Ottenwaelter, Chief Risk Officer, Société Générale
- Anton van Rossum, Director, Credit Suisse
- Anthony Wyand, Audit, Internal Control, and Risk Committee Chair, Société Générale and Internal Controls and Risk Committee Chair, UniCredit

Appendix 2: Interviewees

In addition to the meeting participants, during January and March 2012, Tapestry Networks and Ernst & Young have engaged 49 risk officers, non-executive directors, supervisors, and banking professionals in discussions regarding top and emerging risks. Interviewees included:

Directors and executives

BNY Mellon

- Nicholas Donofrio, Risk Committee Chair, Executive Committee Member, Corporate Social Responsibility Committee Member

CIBC

- Gary Colter, Corporate Governance Committee Chair, Management Resources and Compensation Committee Member
- Nicholas Le Pan, Risk Management Committee Chair, Corporate Governance Committee Member

Credit Suisse

- Tobias Guldimann, Chief Risk Officer, Executive Board Member

ICBC

- Sir Callum McCarthy, Strategy Committee Member, Risk Committee Member, Nominations Committee Member

ING

- Joost Kuiper, Audit Committee Chair
- Wilfred Nagel, Chief Risk Officer

JPMorgan Chase

- Sally Dewar, Managing Director, International Regulatory Risk

Lloyds Banking Group

- David Roberts, Risk Committee Chair

Morgan Stanley

- C. Robert Kidder, Lead Director, Compensation Management Development and Succession Committee Member, Nominating and Governance Committee Member
- Donald Nicolaisen, Audit Committee Chair, Compensation Management Development and Succession Committee Member

Rabobank

- Marinus Minderhoud, Audit, Compliance and Risk Committee Chair, Supervisory Board Member

RBS

- Sir Sandy Crombie, Senior Independent Director, Group Sustainability Committee Chair, Risk Committee Member

Société Générale

- Nathalie Rachou, Audit, Internal Control and Risk Committee Member

TD Bank

- Mark Chauvin, Chief Risk Officer
- Brian Levitt, Chairman of the Board, Corporate Governance Committee Chair, Human Resources Committee Member

UBS

- Philip Lofts, Group Chief Risk Officer, Group Executive Board Member
- David Sidwell, Senior Independent Director, Risk Committee Chair, Strategy Committee Member

U.S. Bancorp

- Olivia Kirtley, Audit Committee Chair, Executive Committee Member, Governance Committee Member
- Jerry Levin, Compensation and Human Resources Chair, Executive Committee Member, Governance Committee Member

Regulators, supervisors, and policymakers

Federal Reserve Bank of New York

- Sarah Dahlgren, Executive Vice President, Financial Institutions Supervision Group
- Steven Manzari, Senior Vice President, Financial Supervisions Group

Financial Services Authority

- Andrew Bailey, Deputy Head of the Prudential Business Unit, Director of UK Banks and Building Societies

Swiss Financial Market Supervisory Authority FINMA

- Mark Branson, Head of the Banks Division

Ernst & Young

- Andy Baldwin, Sub-area Managing Partner, EMEIA Financial Services
- Chris Bowles, Partner, UK Financial Services Risk Management Lead
- Tom Campanile, Partner, Enterprise Risk Management, Financial Services
- Carmine DiSibio, Vice Chair and Managing Partner, Financial Services
- Patricia Jackson, Head of Prudential Advisory Practice, EMEIA Financial Services
- John Liver, Partner, Financial Services Advisory
- Marcel van Loo, Banking & Capital Markets Leader, EMEIA Financial Services
- Lawrence Prybylski, Global Practice Leader, Financial Services Risk Management
- Chris Richardson, Director, Financial Services
- Tim Rooke, Partner, Risk Advisory Services, EMEIA Financial Services
- William Schlich, Global Banking & Capital Markets Leader, Financial Services
- David Scott, Senior Manager, Financial Services Risk Management
- Donald Vangel, Adviser, Regulatory Affairs, Office of the Chairman