Corporate Governance and Risk Oversight

The Professional Risk Manager’s International Association (PRMIA)

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Introduction

• In August 2012, OSFI released for comment a draft of its long-awaited revised Corporate Governance Guideline (previous guideline was issued in 2003).

• The guideline sets forth OSFI's expectations for corporate governance of federally-regulated financial institutions (FRFIs) and is intended to:
  
  o Further align the regulatory guidelines in Canada to the emerging international standards\(^1\);  
  o Promote industry leading practices in corporate governance; and  
  o Ensure FRFIs establish robust and prudent corporate governance practices that lend to the overall financial stability.

• The update establishes OSFI’s expectations across three fundamental components of corporate governance:

  1. **Role of the Board**: Further clarifying the roles, responsibilities and competencies of the Board to enhance effectiveness of the Boards;

  2. **Risk Governance**: Enhancing the risk governance within the organization by clarifying the roles of the Chief Risk Officer and establishing a Risk Appetite Framework that guides the risk-taking activities of the institution; and

  3. **Audit Committee**: Enhancing oversight framework within the organization by clarifying the roles of the Board and its Committees (especially the Audit Committee) in establishing effective oversight functions.

• On January 28, 2013, OSFI released the final version of its revised Corporate Governance Guideline.

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\(^1\) *Toward Effective Governance of Financial Institutions, G30 Working Group on Corporate Governance*

*The EU corporate governance framework, European Commission*

*The Principles for Sound Compensation Practices, Financial Stability Board*
OSFI’s Corporate Governance Guideline

Role of the Board

- **Approve and Review**: Key policies, business objectives, strategy and plans, Risk Appetite Framework, appointment and performance review/compensation of the CEO, Senior Management. The Board is now expected to approve the mandate, resources (amount and type) and budgets for the oversight functions.

- **Third-party review**: The Board should occasionally conduct a self-assessment with the assistance of independent external advisors to assess the effectiveness of Board and committee governance practices, including incorporating tools such as a competency matrix. Boards should occasionally conduct a benchmarking analysis of oversight functions with the assistance of independent external advisors.

- **Independence**: Separating the roles of Chair and CEO and approving a director independence policy that takes into consideration the specific ownership structure of the institution. Where appropriate, director tenure should also be factored into the independence policy.

Risk Governance

- **Risk Appetite Framework**: Establish a board-approved RAF that guides the amount of risk the FRFI is willing to accept in pursuit of its strategic and business objectives.

- **Risk Management**: Periodically commission independent third-party reviews to assess the effectiveness of the FRFI's risk management systems and practices.

- **Risk Committee**: Depending on the nature, size, complexity and risk profile of the FRFI, the Board should establish a dedicated Board risk committee to oversee risk management on an enterprise-wide basis. Members must be "non-executives" of the FRFI.

- **Chief Risk Officer**: Ensure a designated CRO, with sufficient stature and authority within the organization, and who is also independent from operational management. The CRO should have unfettered access and, for functional purposes, a direct reporting line to the Board or the Risk Committee.

Audit Committee

- **Audit Committee Composition**: Comprise of non-employee directors, a majority of whom are not “affiliated” with the institution.

- **Audit Committee Role**: AC should review the annual statements, evaluate and approve internal control procedures for the institution, and meet with the Chief Internal Auditor to discuss the effectiveness of the institution’s internal controls and the adequacy of reserving and reporting practices. The initial draft stated that the AC, not Senior Management, should be responsible for approving external auditor fees and the scope of the audit engagement. This statement has been softened to the expectation that the AC recommend to the shareholders the appointment, reappointment, removal and remuneration of the external auditors. The AC should annually report to the Board on the effectiveness of the external auditor as well.

- **Oversight Functions**: Obtain assurances from senior management and establish other verification processes, that the persons discharging the oversight functions have the appropriate mandate, resources and organizational structure to fulfill their duties.
How is the industry responding?

Industry participants are responding along the following spectrum:

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<th>Current Governance Practices</th>
<th>Impact Assessment</th>
<th>Next Steps</th>
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| • Independent Board and Committees are established  
  • Oversight functions exist with clear line of reporting to the Board  
  • Independent Chief Risk Officer position may not exist | • Reliance on externally available information  
  • Limited internal impact assessment  
  • No formal strategy in place  
  • Limited regulatory engagement or proactive response | • No formal initiatives identified / launched |
| • In compliance with 2003 OSFI corporate governance guidelines  
  • Oversight functions exist with clear line of reporting to the Board  
  • Chief Risk Officer reports directly to the CEO and has access to the Risk Committee of the Board | • Active participation in the regulatory process  
  • Impact self-assessment of regulations underway  
  • Consideration of changes to existing governance infrastructure e.g. committee frameworks, documentation etc | • Initiated key projects to tackle specific issues e.g. Enhancement of mandates |
| • Strong governance practices in place well beyond the expectations of the 2003 OSFI corporate governance guidelines  
  • Board approved Risk Appetite Framework in place | | • Third party reviews initiated for Corporate Governance practices and effectiveness of oversight functions to identify potential gaps  
  • Key projects underway to enhance and establish new corporate governance practices and infrastructure |
The survey covered over **860 public companies** and of the Directors who responded, over **70% serve on the Boards of companies with more than $1 billion** in annual revenue.

As a result, the survey’s findings reflect the practices and boardroom perspectives of many of today’s world-class companies.

We structured the survey to provide pragmatic feedback directors can use to assess and improve performance in **areas that are “top of mind” to today’s Boards.**

Corporate directors have adjusted to significant changes in the governance environment during the last year. The survey shows **directors are clearly making progress and enhancing their practices. At the same time, directors acknowledge the numerous challenges they still face.**

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Key Highlight: Increased workload for Directors

- Directors’ workloads have substantially increased during the last year.
- The majority of directors (56%) have increased the time they spend on Board work during the last year. More than two-thirds of those (67%) cite an increase of over 10%, and one out of five say their hours increased by more than 20%.
- Compensation committee hours rose for half of the directors responding, and more than one-third of audit committee members increased their hours owing to the pressure on compensation issues these committees respectively need to address.

Changing regulatory focus on corporate governance could further lead to increased pressure on the time commitment for Board work.
The amount of risk a company is willing to accept is its “risk appetite,” and our survey reveals directors are very comfortable with their understanding of it.

Nearly all directors (97%) say they are at least “moderately comfortable” with their Board's understanding of the company’s risk appetite.

Additionally, directors are at least “moderately comfortable” with their understanding of emerging risks, such as the European debt crisis and the impact of natural disasters (91%).
Key Highlight: There is room to improve risk oversight

- Proxy disclosures indicate that there are still financial service organizations that consider risk oversight as a full-board function and don’t have a dedicated risk management committee.

- For efficiency, Boards often allocate oversight of specific risks to their Board committees. However, our survey shows a significant number of directors (37%) believe there is no clear allocation of specific responsibilities for overseeing major risks among the Board and its committees (or are not sure whether there is any such allocation).

- Many directors may understand the risks the company faces, but they are not sure who on the Board is supposed to oversee them.

- This structural disconnect could prove troublesome for companies in the long run.
Key Highlight: Involvement in strategy

- Directors realize the importance of strategy discussions, and virtually all (99%) discuss the continued viability of the company’s strategy at least once a year.

- More than one-third (36%) discuss strategy twice a year and 42% do so at every formal Board meeting.

- Still, directors would like to increase the amount of time they dedicate to strategy oversight going forward. In our survey, strategic planning topped the Board’s “wish list,” with over 75% of directors wanting to devote more time to it during the next year.

- Nearly one-third of directors at smaller organizations, say they would like to spend “much more” time and focus on strategic planning in the coming year, twice the number of directors who felt that way at the largest companies.
Key Highlight: Benchmarks for effective strategy oversight

In our survey, we identified several leading practices that Boards use to oversee their company’s strategy. Then we asked directors which ones have been adopted by their Boards. The results should help directors evaluate the effectiveness of their own approach:

• **Linking Risk with Strategy:** 88% integrate discussions of risk with strategy;

• **Setting return guidelines:** 78% establish minimum guidelines for return on investment from strategic transactions—suggesting that Boards are very sensitive to the potential downfalls of a bad merger or acquisition;

• **Annual meetings for Strategy:** 70% use annual special meetings/retreats to discuss strategy—this suggests directors think strategy is important enough to change the venue. Dedicated time, often at a separate location, may facilitate how effectively the Board interacts and focuses on this important task;

• **Involvement of Senior Management:** 70% evaluate the “buy in” of the company’s leadership team beyond the CEO;

• **External Data:** 66% evaluate external benchmarks and data to independently corroborate management’s assumptions/assertions;

• **Board Input:** 53% consider alternative strategies to those presented by management; and

• **External Counsel:** 26% integrate the input of a strategic consulting firm into strategy considerations.
### PwC’s framework for response

#### Governance and strategy
- Organizational structure and operating model
- Roles and responsibilities
- Policies and procedures
- Committee Structure

#### Risk management processes

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<th>Risk management processes</th>
<th>Business planning</th>
<th>Risk assessment</th>
<th>Risk management</th>
<th>Control and validation</th>
<th>Business evaluation</th>
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</thead>
</table>
| Business planning         | • Risk appetite setting  
                          | • Strategic planning  
                          | • Financial planning  
                          | • Capital budgeting and forecasting  
                          | • New product / new business  
                          | • Enterprise-level limits  | |
| Risk assessment           | • Material risk identification and profile  
                          | • Risk measurement and aggregation  
                          | • Stress testing  
                          | • New product approval process  
                          | • Underwriting and pricing  | |
| Risk management           | • Risk monitoring and limits  
                          | • Performance attribution  
                          | • Corrective actions  
                          | • Issue and action tracking processes  | |
| Control and validation    | • Internal controls  
                          | • Validation controls (e.g. model validation)  
                          | | • Internal audit review  | |
| Business evaluation       | • Risk adjusted performance measurement and review (business reviews)  
                          | • Risk and performance reporting  
                          | • Incentives and compensation  
                          | • Disclosure  | |

#### Risk dimensions

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<th>Risk dimensions</th>
<th>Risk type</th>
<th>Management model</th>
<th>Legal entity</th>
<th>Product</th>
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</table>
| Risk type       | Market risk  
                          | Credit risk  
                          | Liquidity risk  
                          | Op risk  | |
| Management model | Retail banking  
                          | Commercial banking  
                          | Asset mgmt  
                          | Other  | |
| Legal entity    | Global Locations  
                          | Separate Legal Entities  | | |
| Product         | Mortgages  
                          | Consumer loans  
                          | Commercial loans  
                          | Cards  
                          | Wealth  | |

#### Analytics and infrastructure

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<th>Analytics and infrastructure</th>
<th>Risk inventory</th>
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<th>Stress testing</th>
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<th>Performance measures</th>
<th>Control indicators</th>
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<td>Data</td>
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<td>Resources</td>
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## Corporate Governance – Sample Elements of Review

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<th>Element</th>
<th>Description of Assessment Criteria</th>
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<tr>
<td><strong>Board Composition</strong></td>
<td>Approach to recruit members who collectively bring a balance of expertise, skills, experience, and perspectives and who exhibit irreproachable independence of thought and action.</td>
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<tr>
<td><strong>Oversight</strong></td>
<td>Assessment of the Board’s understanding and involvement in all matters concerning the strategy, risk appetite, and conduct of the firm, and an understanding of the risks it faces and its resiliency.</td>
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<tr>
<td><strong>Organizational structure</strong></td>
<td>Assessment of the Board’s role in appointing individuals for key management positions including the CEO, CRO, CFO and the Chief Internal Auditor.</td>
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<td><strong>Interaction with Management</strong></td>
<td>Assessment of the Board’s role in providing a robust challenge to the management through a discussion all strategic proposals, key risk policies, and major operational issues.</td>
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<tr>
<td><strong>Monitoring</strong></td>
<td>Assessment of the Board’s role in establishing robust processes to monitor organizational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations. Assessment of the process in place by the Board to proactively follow up on potential weaknesses or issues.</td>
</tr>
<tr>
<td><strong>Self Assessment</strong></td>
<td>Review the processes in place to regularly and periodically assess the Board’s own effectiveness with the assistance of internal/external advisers.</td>
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<tr>
<td><strong>Risk Appetite</strong></td>
<td>Assess the role of the Board Committees in approving the firm’s risk appetite, overseeing the risk function, infrastructure. Assess if the risk appetite is clearly articulated, linked to the firm’s strategy, embedded in the culture of the firm, and enables appropriate risk taking.</td>
</tr>
<tr>
<td><strong>Reporting</strong></td>
<td>Assess the level, quality and adequacy of risk information provided to the directors to ensure understanding of existing and emerging risks. Assess the robustness of risk information technology systems and their ability to generate timely, comprehensive, cross-geography, cross-product information on exposures.</td>
</tr>
<tr>
<td><strong>Interaction with Board</strong></td>
<td>Review Management’s role in educating and informing directors on an ongoing basis. Assess Management’s role in initiating dialogue with the Board on the key issues and bringing the Board early into Management’s thinking on key decisions.</td>
</tr>
<tr>
<td><strong>Risk Culture</strong></td>
<td>Assess Management’s role in establishing a culture of no surprises, the quick elevation of issues and organizational learning.</td>
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<td><strong>Clarity of roles</strong></td>
<td>Assess the clarity and appropriateness of the roles and responsibilities across the three lines of defence.</td>
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Sample Elements of Review – Oversight Function

Mandate and Scope

• Adequacy of the mandate
• Scope of the oversight function
• Stature and Independence
• Challenge role

Org. Structure

• Org structure facilitates informed management decision making and supports efficient flow of information
• Issue escalation
• Alignment of risks to management committees

Resources

• Resources adequacy
• Skills and qualifications
• Training
• Compensation
• Performance management

Infrastructure

• Appropriateness of the infrastructure
• Policy, Standards and Guidelines
• New Product Approval process
• Risk Reporting
• Emerging Risks
Example leading practices...

- The Board plays a pivotal role in the success of a FRFI through the approval of the FRFI’s overall business and risk strategy

- Senior Management is responsible for implementing the Board approved risk strategy

- Directors spend time in ensuring alignment of strategy to risk appetite. Boards discuss strategy at least twice a year with management and also at each Board meeting

- The Board periodically commissions independent third-party reviews to assess the effectiveness of Board and Board Committee practices and obtain a view on peer practices

- A dedicated Board level committee is established to oversee risk management related activities on an enterprise-wide basis

- The heads of control functions have adequate stature and independence within the organization to effectively execute their mandates

- Highly effective Boards include a mix of individuals with the appropriate expertise and experience to bring the right dynamics.

- Clear allocation of specific responsibilities exists for overseeing major risks among the Board and its committees (or are not sure whether there is any such allocation).