Director Notes

Risk Oversight

Should Your Board Have a Separate Risk Committee?

by Carol Beaumier and Jim DeLoach

It is generally accepted that the full board has overall responsibility for risk oversight, mirroring the board's responsibility for overseeing strategy. In deciding how to organize itself to oversee risk and risk management, the question arises as to whether the board should establish a separate risk committee. This article explores that question and provides examples to clarify the role and responsibility of a separate risk committee in situations where the board decides to establish one.*

Through the risk oversight process, the board of directors obtains an understanding of the critical risks inherent in the corporate strategy, accesses useful information from internal and external sources about the critical assumptions underlying that strategy, remains alert to organizational dysfunctional behavior that can lead to excessive risk taking, and provides input to executive management regarding critical risk issues on a timely basis. How the board views risk oversight as a process should dictate how it chooses to organize itself for purposes of executing that process. The risk oversight process enables the board and management to develop a mutual understanding regarding the risks the company faces over time as it executes its business model for creating enterprise value. In organizing itself for risk oversight, what are some of the factors for boards to consider and when should boards establish a separate risk committee?

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Overall Responsibility for Risk Oversight

The full board should retain *overall* responsibility for risk oversight, mirroring its overall responsibility for strategy. If the board is to fully understand the company's corporate strategy, it also needs to determine the risks inherent in that strategy. If the full board is responsible for monitoring execution of the strategy, it needs to understand whether the critical risks are being managed effectively. This oversight can be carried out either by the full board or through delegation to one or more standing committees, provided that overall responsibility for the process remains with the full board.

Except where there are statutory requirements dictating otherwise, the board has the flexibility to organize itself in a manner that makes sense in view of the company's size, structure, complexity, culture, and risk profile, as well as the board's size, composition, and structure. To enhance effectiveness and efficiency and address specific regulatory requirements, specific risk oversight responsibilities can be allocated to various standing committees in keeping with the specific risks germane to each committee's responsibilities. This delegation of responsibility can be accomplished in different ways, including a separate risk committee and expansion of the role of the audit committee and the various other committees of the board (finance, strategy, etc.).

Should Risk Oversight Be the Responsibility of the Audit Committee?

In determining whether to designate the audit committee as the body responsible for risk oversight, the board must consider a critical question: Does the audit committee have the time, the skills, and the support to do the job, given everything else it is required to do? In our experience, when audit committees assert that they are addressing risk management, their scope tends to be all over the map. If the board decides that the audit committee is the right choice to provide risk oversight, it should acknowledge that the audit committee already has many responsibilities focused on financial reporting and is, in effect, the last line of defense for financial reporting risk—a point that should not be taken lightly if the enterprise's financial reporting issues are complex. The so-called "audit committee financial expert"—a fixture on many audit committees of public companies as a result of the Sarbanes-Oxley Act—may not necessarily have the skills needed to evaluate policies for assessing and managing the range of business and operational risks the enterprise faces. In fact, off-balance sheet reporting and other financial reporting practices sanctioned by companies and their audit committees have often obscured the very transparency so necessary for effective risk management and risk oversight. Therefore, the complexity of the company's risks may justify a different approach than delegating primary responsibility for risk oversight to the audit committee.

Determining Whether to Establish a Separate Risk Committee

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires a separate risk committee composed of independent directors for publicly traded bank holding companies with $10 billion or more in assets and publicly traded nonbank financial companies supervised by the Federal Reserve. Over time, we may see some "trickle-down effect" from this approach to the board risk oversight of nonfinancial companies. Given this context, the question arises as to whether the board should establish a separate risk committee for the board.

A separate risk committee of the board is not a one-size-fits-all solution, and it may be a better fit for companies with special circumstances. For example, the boards of financial institutions, power companies, and other organizations with complex market, credit, liquidity, commodity pricing, regulatory and other risks that require special attention may find a risk committee useful. Companies with rapidly changing business environments and expecting significant emerging risks, such as quickly evolving technological innovation and cybersecurity risks, might also find a separate risk committee of value.

A risk committee focuses director attention on the company's most critical risks and risk management capabilities. To this end, the board will want to be sure that the directors assigned to this committee have the requisite knowledge and expertise to provide effective oversight over the risks falling within the committee's scope. A risk committee fosters an integrated, enterprise-wide approach to identifying and managing risk and provides an impetus toward improving the quality of risk reporting and monitoring, both for management and the board. This approach can assist the board in focusing on the "big picture." A risk committee can also provide greater support for company executives who are given broad risk management responsibilities, resulting in a stronger focus at the board level on the adequacy of resources allocated to risk management. Finally, it allows the audit committee and other board committees to focus on their respective core responsibilities.

Dodd-Frank Provisions Regarding Risk Committee

Dodd-Frank requires a separate risk committee for:

(1) Nonbank financial companies supervised by the Board of Governors that are publicly traded companies.

(2) Certain bank holding companies, that are publicly traded and have total consolidated assets of not less than $10 billion. The Board of Governors may require a publicly traded company with total consolidated assets of less than $10 billion to establish a risk committee to promote sound risk management practices.

According to Dodd-Frank, a risk committee shall:

(A) Be responsible for the oversight of the enterprise-wide risk management practices of the nonbank financial company supervised by the Board of Governors or bank holding company;

(B) Include such number of independent directors as the Board of Governors may determine appropriate, based on the nature of operations, size of assets, and other appropriate criteria related to the nonbank financial company supervised by the Board of Governors or a bank holding company; and

(C) Include at least 1 risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms.

Source: Dodd-Frank Act Section 165(h).

A separate risk committee, however, is not a panacea. A number of issues can arise during the formation of a separate risk committee:

- Without a sufficient number of independent directors who possess deep knowledge and experience in dealing with the industry and its critical risks, a risk committee will lack effectiveness.
- A risk committee cannot cover any gaps in the company's risk management process and is highly dependent upon the quality of inputs to and outputs from that process and information and insights from external sources.
- Redundant activity can arise as risk management issues are considered through the work of other board committees.
- Most board members serve on several committees already; therefore, adding one more committee can dilute the board's focus.

When deciding whether to form a separate risk committee, it is important to consider the extent to which risks are already inherent in the scope of each standing committee's activities as set forth in the respective committee charter. For example:

- Audit committees typically oversee financial reporting risks and certain compliance-related risks that can have financial reporting implications. For companies listed on the New York Stock Exchange (NYSE), the audit committee is required to include in its charter a responsibility to discuss with management the company's policies around risk assessment and risk management, even if the board sees fit to set up a separate risk committee.
- Governance committees oversee such governance risks as board leadership and composition, board structure, and other matters.
- Compensation committees oversee risks related to how the compensation structure drives behavior within the organization.
- Strategy and finance committees oversee strategic risks.

Defining the risks that fall within the purview of a separate risk committee will tend to vary widely based on the nature of the industry and the complexity of the organization's risks, requiring focused expertise to provide appropriate oversight. Therefore, whether to establish a separate risk committee is a facts-and-circumstances decision based on many factors. Regardless, the full board has the responsibility to provide effective risk oversight. With that in mind, the board must decide how best to organize itself for risk oversight. If a separate risk committee is formed, the board needs to be careful that the existence of a risk committee does not result in the rest of the board neglecting risk matters because of a view that risk is an issue only for the separate risk committee to consider.

Some companies form a separate committee to address specific company risks but don't call the committee a "risk committee." The idea is to charter a committee to deal with the unique, complex, and volatile risks the company faces. To illustrate, the boards of Dow, Ashland Inc., and Veresen Inc. have an environmental, health, safety and technology committee, and the board of Chiquita Brands has a food innovation, safety and technology committee. Hewlett-Packard's board has a technology committee and Monsanto's board has a science and technology committee.Separate risk committees have been the norm for years in financial institutions and are becoming commonplace at companies that fall under the provisions of Dodd-Frank, as well as among many smaller institutions. Risk committees are emerging in nonfinancial services companies as well. For example, according to disclosures in their respective proxy statements, GE has a risk committee, GM has a finance and risk policy committee, Owens-Illinois, Inc. has a risk oversight committee, and The Hershey Company and Duke Energy both have a finance and risk management committee. Many companies have an audit and risk committee (or conversely, a risk and audit committee), including a number of financial services companies, as well as Intuit Inc., Ameren Corporation, BHP Billiton, and many others.

As dramatic global events continue to bring home the reality that it is, indeed, a risky world out there, interest in increasing the board's focus on risk oversight is prompting more consideration of the merits of a separate risk committee. The U.S. Securities and Exchange Commission rules now require disclosure of the board's risk oversight process, providing transparency to institutional investors so they can understand more about what boards are doing in overseeing risk. Those disclosures and the interest they create has encouraged boards to think about how they are organizing for risk oversight.

Role and Responsibilities of a Separate Risk Committee

To enhance the transparency of the oversight process, organizations may want to consider documenting formally the roles and responsibilities related to risk oversight in the board and/or committee charters. Specifically, they may want to clarify which responsibilities and duties will be handled by the full board and which of these will be delegated to the responsible standing committees to ensure major gaps and overlaps in oversight of top risk exposures do not occur.

New York Stock Exchange Listing Requirements

(b) The audit committee must have a written charter that addresses (iii) the duties and responsibilities of the audit committee as well as to (D) discuss policies with respect to risk assessment and risk management.

Commentary While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

Source: Based on NYSE Listed Company Manual 303A.07 Audit Committee Additional Requirements.

If a separate risk committee is deemed appropriate given the risk oversight responsibilities outlined in the various standing committees' charters, it might take on some of the following roles:

- Determine that there is a robust process in place for identifying, managing, and monitoring critical risks; oversee execution of that process; and ensure it is continuously improved as the business environment changes.
- Provide timely input to executive management on critical risk issues.
- Engage management in an ongoing risk appetite dialogue as conditions and circumstances change and new opportunities arise.
- Oversee the conduct of, and review the results of, enterprise-wide risk assessments, including the identification and reporting of critical enterprise risks.

- Oversee the management of certain risks having the complexity and significance to warrant the attention of a separate board committee composed of directors with the requisite expertise.
- Help coordinate activities of the various standing committees for risk oversight.
- Watch for dysfunctional behavior in the company's culture that could undermine the effectiveness of the risk management process and lead to inappropriate risk-taking, such as (in cooperation with the compensation committee) the nature and balance of the compensation structure and its potential to encourage inappropriate risk-taking.

The risk committee charter should clarify that the committee's activities support the board's overall risk oversight objectives. With respect to risks the risk committee is assigned to oversee, care should be taken to watch for overlaps (e.g., compliance risk with the audit committee). For examples of risk committee charters for financial and nonfinancial institutions, see pp. 6-8.

Conclusion

However the board decides to proceed in organizing risk oversight, it must have a balance of qualified directors. Knowledge of the industry and its critical risks is vital for companies with significant financial and commodity-based risks. If that knowledge is lacking, it won't matter which risk oversight option the board selects.

It is also imperative that directors have access, from both internal and external sources, to the information and insights conducive to effective risk oversight. Ineffective risk reporting renders moot any discussion about organizing for risk oversight. The findings of a December 2010 survey of more than 200 directors regarding the current state of board risk oversight point to an opportunity to enhance risk reporting to the board. The survey, sponsored by the Committee of Sponsoring Organizations (COSO) and published by Protiviti, showed that the most common types of risk reporting received at least annually by boards include a high-level summary of top risks for the enterprise as a whole and its operating units; a periodic overview of management's methodologies used to assess, prioritize, and measure risk; and a summary of emerging risks that warrant board attention.[1] The types of risk reporting not received annually by most boards include scenario analyses evaluating the effect of changes in key external variables affecting the organization; a summary of exceptions to management's established policies or limits for key risks; and a summary of significant gaps in capabilities for managing key risks and the status of initiatives to address those gaps. The findings reveal an opportunity for organizations to improve the risk reporting process and increase the regularity of reporting according to the nature of the organization's operations and risk profile as well as the board's specific needs.

Finally, if various standing committees are used for the purposes of risk oversight with no enterprise-wide focus, there is the danger that boards will miss the big picture. The use of various committees can lead to a fragmented and silo-driven approach, which can result in critical risks being omitted from consideration. That is why the risk oversight approach should be carefully orchestrated at the full board level.

Questions for Boards

Boards of directors may consider, in the context of the nature of the risks inherent in the company's operations:

- Has the board considered how it should organize for risk oversight? Is a separate risk committee mandated by regulation or regulatory expectation? Has the board articulated its risk oversight objectives and are those objectives incorporated into the board's charter? Has the board evaluated the effectiveness of its risk oversight processes in achieving its risk oversight objectives? Is the board actively taking steps to address any gaps that may impede its risk oversight effectiveness?
- Is the board satisfied that its current complement of directors has the requisite expertise and industry knowledge to provide effective oversight of the company's most critical risks?
- Are the board and/or responsible committees, including a separate risk committee, if one exists, confident that directors are receiving the comprehensive, objective information they need to perform effective risk oversight? Is sufficient agenda time allocated to the discussion of the enterprise's risks with the appropriate company individuals?
- Is there a robust process in place for identifying, prioritizing, sourcing, managing, and monitoring the enterprise's critical risks in a changing business environment? Does that process adequately support the board's risk oversight?
- Does the board understand the risks inherent in the corporate strategy? Is there a sufficient understanding of the significant assumptions underlying the strategy and is a process in place to monitor for changes in the environment that could alter those assumptions?

1 "Board Risk Oversight – A Progress Report: Where Boards of Directors Currently Stand in Executing their Risk Oversight Responsibilities," Protiviti, December 2010 (www.coso.org/documents/Board-Risk-Oversight-Survey-COSO-Protiviti_001.pdf).

Risk Charter Examples

Example of Risk Committee Charter for a Bank

(Note: This charter must be tailored to the company's strategy, structure, culture, risk appetite, and risk profile.)

Mission The Risk Committee (the "Committee") is a standing committee of the Board of Directors ("Board"). The purpose of the Committee is to assist the Board in fulfilling its responsibilities with respect to:

- Ensuring that the Bank has an effective process in place for the ongoing identification and assessment of risk, including emerging risks.
- Approving the Bank's risk appetite and related metrics and reviewing on an ongoing basis the Bank's actual risk profile against its risk appetite metrics.
- Approving risk management policies that establish the appropriate approval levels and limits for managing key risks.
- Assessing the overall adequacy of the Bank's risk management function.

The Committee's role is one of oversight and the Committee's activities do not substitute for the responsibility of Management to design, implement, and maintain an effective risk management program.

Composition The Committee shall consist of three or more independent directors, who shall be appointed annually by the Board of Directors based on the recommendation of the Nomination and Governance Committee. Members of Management, including the CEO, President, and COO, and the Chief Risk Officer, will meet regularly with the Committee, but shall not be considered Committee members. The Committee has the authority to engage independent advisors, paid for by the Bank, as it deems necessary to make the best possible decisions on risk management.

Meetings The Committee shall meet at a minimum four times annually, or more frequently as circumstances dictate. The Committee shall at its discretion meet without Management and/or with the Chief Risk Officer without other members of Management present. The Committee may also meet periodically with the Audit Committee (to the extent Audit Committee members are not also members of this Committee) to discuss topics of mutual interest; may meet with the Bank's regulators with or without Management; and may meet with the Management Risk Committee (composed of the CEO, President & COO, Director of Administration, Chief Credit Officer, Chief Financial Officer, and Chief Risk Officer).

Specific Responsibilities and Duties In addition to any specific duties that may be prescribed by regulation, the Committee has the responsibility to:

- Ensure that the Bank has a robust risk governance system in place.
  - Based on the recommendation of the Chief Risk Officer, review and approve the Bank's risk appetite and risk appetite governance framework at least annually.
  - Review the Bank's actual risk profile and risk trending against its risk appetite based on management reports; such ongoing reviews will include, but not be limited to, monitoring of any policy exceptions affecting the Bank's risk profile, reviewing results of stress-testing and scenario analysis, reviewing results of model validation testing, and consideration of the impact on the Bank and its risk profile of the work performed by any third-party providers (with the exception of providers of internal and external audit services, which will be evaluated by the Audit Committee).
  - Evaluate whether the Bank's incentive compensation programs support its risk management objectives and is regulatory compliant.
- Receive presentations and other information to understand the existing and emerging risks to which the Bank is exposed and ensure that there is a robust process in place for challenging how the Bank identifies and assesses its risks.
- Review and approve significant risk management policies and procedures, including those for:
  - Credit risk (including ALLL)
  - Market risk
  - Interest rate risk
  - Liquidity risk
  - Investment risk
  - Regulatory and legal risk
  - Operational risk (except to the extent this relates to the review function performed by the Audit Committee)
  - Reputational risk

- Confirm the appointment and dismissal of the Chief Risk Officer and at least annually give the CEO its evaluation of the performance of this individual.
- At least annually, assess the effectiveness of the risk management function.
- Report to the Board (and the Audit Committee, as warranted) material matters discussed at Committee meetings.
- Periodically participate in educational sessions to enhance their knowledge of risk-related issues.

In carrying out these duties and responsibilities, the Committee shall foster an environment which encourages the Chief Risk Officer or any other Bank officer or employee to raise any risk issues or concerns freely and without concern for retribution.

Periodic Assessment of Committee Mission and Effectiveness There will be an annual evaluation of the Committee's contribution and effectiveness. This may be a self-evaluation or may be performed using other resources or procedures as the Committee and the Nomination and Governance Committee determine. As a result of this review, the Committee may recommend to the Board changes in this Charter.

Example of Risk Committee Charter for a Nonfinancial Services Company

(Note: This charter must be tailored to the company's strategy, structure, culture, risk appetite, and risk profile.)

Mission While the overall responsibility for risk oversight rests with the full Board of Directors, the Risk Committee of the Board shall consist of a minimum of three independent directors under the New York Stock Exchange's listing requirements. The Committee is responsible for:

- Providing oversight of management's guidelines, policies, and processes for monitoring and mitigating the company's critical enterprise risks, including the major strategic, operational, financial, and compliance risks inherent in the company's business;
- Determining which risks need to be included on the Board's agenda for discussion; and
- Assisting the board in its oversight of the company's management of key risks that have the potential to significantly affect the Company's ability to execute its strategic priorities and achieve its performance goals.

The Committee shall not have responsibility for matters subject to the jurisdiction of another committee of the Board of Directors pursuant to that committee's charter. However, to fulfill its responsibility to determine which risks should be included on the Board's agenda, it is expected that all significant risks be communicated to the Committee, through either direct communication or reporting from other Board committees.

Composition The Committee shall consist of a minimum of three independent directors under the New York Stock Exchange's listing requirements. The members of the Committee shall be appointed by the Board upon the recommendation of the Governance Committee and shall serve until such member's successor is duly elected and qualified or until such member's earlier resignation or removal. The members of the Committee may be removed, with or without cause, by a majority vote of the Board.

Meetings The Committee shall meet at least four times annually, or more frequently as circumstances dictate. The Chairman of the Board or any member of the Committee may call meetings of the Committee. Unless a Chairman of the Committee is elected by the Board, the members of the Committee shall designate a Chairman by majority vote of the full Committee membership. The Chairman shall:

- Chair all regular sessions of the Committee;
- Set the agendas for Committee meetings;
- Coordinate with the chairman of the Audit Committee to assist the Audit Committee in its review of the company's risks that have been delegated to the Audit Committee in its charter and review, and assess and discuss with appropriate company executives the company's underlying policies with respect to risk assessment and risk management; and
- Coordinate with the chairman of the Compensation Committee to assist it in its consideration of the relationship between risk management policies and practices, corporate strategy and senior executive compensation.

All directors that are not members of the Committee may attend meetings of the Committee but may not vote. Additionally, the Committee may invite to its meetings any director, company executive, guest presenter or outside expert as it deems appropriate in order to carry out its responsibilities, and shall have the authority to approve the retention terms, fees and expenses of any outside advisors it chooses in its sole discretion. In addition, the Committee may also exclude from its meetings any persons it deems appropriate in order to carry out its responsibilities.

Specific Responsibilities and Duties The committee shall have the following authority and responsibilities:

- Review and discuss with management the company's risk governance structure, risk assessment, and risk management practices and the guidelines, policies, and processes for risk assessment and risk management;
- Review and discuss with management the company's risk appetite and strategy relating to critical enterprise risks and emerging risks, as well as the guidelines, policies, and processes for monitoring and mitigating such risks;
- Review the company's progress in developing and maintaining the appropriate risk management culture;
- Receive, as and when appropriate, reports from the company's internal audit function on the results of risk management reviews and assessments;
- Review disclosure regarding risk contained in the company's Annual Report on Form 10-K and Quarterly Reports on Form 10-Q and other filings with the Securities and Exchange Commission;
- Review reports on selected risk topics as the Committee deems appropriate from time to time; and
- Provide the Board an overview of the results of the Committee's oversight activities and recommend specific critical enterprise risks and emerging risks that warrant the Board's oversight and attention.

In addition to the above functions, the Committee shall also carry out any other responsibilities and duties delegated to it by the Board from time to time. Risk assessment and risk management are the responsibility of the company's management. The Committee has an oversight role and, in fulfilling that role, it relies on the reviews and reports described above.

Periodic Assessment of Committee Mission and Effectiveness There will be an annual evaluation of the Committee's contribution and effectiveness. This may be a self-evaluation or may be performed using other resources or procedures as the Committee and the Governance Committee determine. As a result of this review, the Committee may review and reassess the adequacy of this charter annually and recommend any proposed changes to the Board for approval.

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