BOARD EFFECTIVENESS: THE FED'S GUIDANCE SPEAKS TO RESILIENCY

Recently, the Federal Reserve in the United States issued guidance for certain financial institutions regarding a board's role in sustaining financial and operational resilience. Aspects of this guidance warrant consideration by directors in other sectors.

On February 26, 2021, the Board of Governors of the Federal Reserve System (FRB) in the United States issued expectations for boards of large financial institutions as a standard for its regulators when they assess board effectiveness. The guidance applies to all domestic bank holding companies and savings and loan holding companies with total consolidated assets of US$100 billion or more, with certain exceptions, as well as systemically important nonbank financial companies designated by the Financial Stability Oversight Council for FRB supervision.

The FRB intends to use the guidance to inform its assessment of governance and controls, one of the three components of its large financial institution rating system.[1] Over time, we are likely to find the FRB extending this guidance to smaller institutions.

The FRB's guidance is significant because a regulator's view on board effectiveness has been expressed to the market, and it reinforces the existing lexicon concerning minimum expectations for boards. Its focus applies to the board's role in maintaining the firm's safety and soundness and responsibility for sustaining financial and operational resilience. As resilience has proven to be a key differentiator in separating the market's winners and losers over the past year, the FRB's principles-based guidance on the key attributes of effective boards — while

[1] The three component ratings for the large financial institution rating system are Capital Planning and Process, Liquidity Risk Management and Positions, and Governance and Controls.

only required for certain financial institutions — merits consideration by boards in other sectors and other countries as well.

Specifically, the guidance outlines five principles:

Oversee the development, review and approval of the firm's strategy and risk appetite and periodically monitor execution and progress. The board advises management in formulating strategy. Based on a comprehensive view of risks and rewards over the planning horizon, the strategy should articulate a firm's objectives for its various lines of business while also establishing an effective risk management structure; appropriate processes and resources for implementing the strategy, supported by plans and budgets; and an effective risk management and control function. The strategy should align with a clear risk appetite that is articulated in sufficient depth to enable the firm's chief risk officer (CRO) and independent risk management function to set firmwide risk limits that will constrain risk-taking to an acceptable level. This alignment provides direction to senior management in determining the opportunities to pursue consistent with the firm's risk management capabilities. It also helps maintain sufficient financial and operational strength and resilience for safety and soundness.

An effective board reviews and approves significant policies, programs and plans based on the firm's strategy, risk appetite, risk management capacity and structure (e.g., the firm's capital plan, recovery and resolution plans, and liquidity risk management policies, among other things). These items may be presented to the board in summarised form in sufficient detail and context for directors to make an informed decision. Understanding relevant policies, programs and plans provides a useful context when considering a new line of business, expansion into a new jurisdiction, and growth strategies within current businesses and products.

Direct senior management regarding the board's information requirements. The board should provide direction to senior management regarding the sufficiency, quality, timing, reliability and structure of information and data directors need to make well-informed decisions. The board should also seek information through channels other than the executive team about the organisation and its activities, ongoing and emerging opportunities and risks, personnel, compensation, and other matters. Finally, the lead independent director or independent board chair and committee chairs should take an active role in setting board and committee meeting agendas.

Hold senior management accountable for results. An effective board oversees and holds senior management accountable for effectively implementing the firm's strategy, consistent with its risk appetite. To facilitate accountability, the board should allocate sufficient board meeting time to candid and open discussions that encourage diverse views. The board should regularly evaluate senior management performance and compensation and consider whether and how compensation programs implemented by senior management promote the firm's risk management goals.

An effective board sufficiently empowers independent directors who serve as an effective check against senior management, including firm executives who sit on the board. For example, if the board has an executive chair, independent directors may be empowered through the election of a lead independent director with authority to call board meetings with or without the chair present. The board also oversees the development and execution of CEO succession plans and, depending on the firm's size, complexity and nature, those of the CRO, chief audit executive (CAE) and other appropriate executives.

Support the independence and stature of independent risk management and internal audit. Through its risk and audit committees, the board assesses and supports the stature and independence of the firm's independent risk management and internal audit functions. This means the lines of business should not unduly influence either of the two functions.

The risk and audit committees should inquire into the causes and consequences of material or persistent breaches of the firm's risk appetite and risk limits, the timeliness of the remediation of material or persistent internal and external audit and regulatory findings, and the appropriateness of the annual audit plan. The risk committee should communicate directly with the CRO, offering unrestricted access to it on significant risk management issues, and advise the CRO on the independent risk management function's budget and staffing, as well as internal controls systems. And the audit committee also should meet with the CAE regarding the audit function's plan and staffing, organisational concerns, and industry concerns.

Maintain a capable board composition and governance structure. Based on factors such as the firm's asset size, complexity, scope of operations, risk profile and changes over time, an effective board establishes a process to identify and select potential director nominees with a mix of skills, knowledge, experiences and perspectives. This process should consider a potential nominee's expertise, availability, integrity and potential conflicts of interest, and be open to a diverse pool of potential nominees, including women and underrepresented minorities. An effective board also has the capacity to engage third-party advisers, when appropriate, to support its decision-making processes. On an ongoing basis, the board should evaluate its committees' performance and adapt its committee structure and practices to address identified deficiencies over time.

So, what are the takeaways? The FRB guidance does not break new ground, but boards should, nonetheless, pause for reflection. The five principles above reveal attributes that allow each board the flexibility to operate according to each organisation's circumstances, complexities and needs with an emphasis on maximising resiliency in the face of disruptive change rather than a prescriptive one-size-fits-all approach.

Although most boards outside of financial services do not have both an audit and a risk committee, these principles point to the following actions that directors should take if they haven't done so, regardless of sector or country:

- Raise the board's line of sight to a strategic focus by allocating more agenda time to look forward and set strategic direction rather than look backward at historical performance.
- Set appropriate parameters around core values and opportunity-seeking behaviour to avoid unbridled risk-taking and violations of laws and regulations.
- Ensure that management and the board have the information and data needed to make informed strategic decisions.
- Exercise diligence in advising management in the execution of the strategy and achievement of performance goals; however, in addition to holding management accountable for results, expect management to build resilience into strategic plans, balance sheets and business models.
- Support the risk management and audit functions in meeting the board's expectations and maximising their value contributed to the organisation.
- Periodically review board composition to ensure the board has the expertise needed to advise the CEO and executive team in the face of changing markets and disruptive change.

Although banks have their unique characteristics, many of the FRB's board effectiveness fundamentals have broad applicability to other sectors. Boards need to think about their role in setting strategy, establishing boundaries and limits, clarifying accountability for results, supporting risk management and internal audit, and periodically evaluating composition and governance structure in changing markets. Accordingly, while only certain qualifying financial institutions in the United States must follow the FRB's guidance, there are sound practices embodied in these five principles worthy of consideration by boards serving smaller banks and those serving companies in other sectors across the world.

How Protiviti Can Help

As the COVID-19 pandemic continues to disrupt business activity across the globe, organisations are reconfiguring the workplace and adopting new business practices to align with changing market realities. As they do so, they are confronting questions related to their resiliency in sustaining customer engagement, shifting to a distributed hybrid workplace, adopting appropriate security measures around the enabling technologies they deploy, and implementing ongoing changes in business models and processes.

Protiviti has the experience, know-how and expertise to help companies navigate these challenges. We can provide companies with access to industry, digital and innovation talent who can bring disruptive thinking to the table in helping them rethink their business, not just in the short term but also in the medium to longer term. Companies can benefit from working with our professionals who share their values, have knowledge and understanding of the technologies they deploy, and draw on a risk perspective.

Audit Committee Self-Assessment Questions

In these dynamic times, it is best practice for boards and their standing committees and individual directors to self-assess their performance periodically and formulate actionable plans to improve board performance based on the results of that process. To that end, audit committees should consider the illustrative questions we have made available at ***www.protiviti.com/US-en/insights/bulletin-assessment-questions-audit-committees****. These comprehensive questions consider the committee's composition, charter, agenda and focus, and may be customised to fit the committee's assessment objectives in light of current challenges the company is facing.*