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Adapting to the board's new normal

How OSFI's new governance oversight unit raises the bar for financial services risk and compensation committees

In an April 22nd speech¹, Superintendent Julie Dickson announced that Canada's Office of the Superintendent of Financial Institutions (OSFI) had recently created a unit charged with overseeing the effectiveness of corporate governance within the institutions it monitors. OSFI's rationale is that, in Dickson's words, "boards are a key control on risk appetite," but also that, as assistant superintendent Ted Price observed in a subsequent speech², in the two years since the 2008 financial crisis, "financial institutions have yet to prove that the behaviours that fueled the crisis have changed".

OSFI presumably hopes that improved governance at the board level will ensure such changes do take place, and will in turn forestall the need for additional, and possibly excessive, regulation. In setting up its oversight unit, the supervisor is assigning to boards an increased level of accountability for managing risk – a responsibility that OSFI itself adopted in 2009 in the wake of the recent financial crisis.

At the end of 2008 and throughout 2009, the G-20, its member states, and related institutions (particularly the Financial Stability Board) attempted to identify both the underlying causes of the financial crisis and ways of preventing or mitigating future crises. One of the key areas of focus was the relationship between risk-taking and incentive compensation at financial services firms, and the degree to which such risks were adequately supervised and quantified. Numerous studies recommended changes to minimize unnecessary risk-taking such as the increased use of bonus deferrals, more stringent clawback policies and enhanced board oversight of risk and compensation matters.

¹ http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/jdemp20100422_e.pdf

² http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/tp20100510_e.pdf

In mid-2009, OSFI announced that it would conduct an “audit” of risk-related compensation policies and practices amongst the Canadian banks and insurance companies. This initial task now largely finished, the creation of OSFI’s new unit marks the institutionalization of governance oversight and an important shift in emphasis from diagnosing the causes of the previous crisis to preventing the emergence of the next. OSFI’s announcement would seem to indicate that from the supervisor’s perspective, significant work is still to be done.

OSFI’s announcement also suggests that significant concern exists as to the adequacy of the role currently played by the board of directors in the governance of risk. As happened in regard to the role of audit committees in the wake of Sarbanes-Oxley legislation, expectations have increased on the part of regulators and broader society: no longer can boards delegate risk management entirely to a firm’s executives. The standard from here on is that directors will be accountable for systematically engaging with the issue, asking tough questions, and withholding approval for proposed policies or strategies until such questions have been sufficiently answered.

To address this burden effectively, financial institution boards and their committees – specifically, their risk and compensation committees – will, to varying degrees, need to strengthen their capabilities. Based on OSFI’s prior and recent pronouncements, there is an expectation that Boards and their members will need to:

- **Become better versed in the business itself:** the way it creates economic value (both product by product and as a whole), the risks it necessarily takes on to create this value, and the rewards it and its shareholders should expect for those risks.
- **Improve their processes:** risk committees will need to add compensation to their agendas, while compensation committees will need to add risk; both committees may require consideration of each other’s most important decisions or reports; compensation committees should ensure that the question “what will this do to risk behaviour?” is considered before every change to a compensation program; board-sponsored audits of the interplay between risk and compensation should already be an essential annual exercise (just as audits of the company’s financials are).
- **Improve their skills:** risk and risk management are among the most complex parts of the financial services business, and having the right skills will be crucial if board committees are to exert effective oversight. Though directors appointed to risk management committees will often have significant experience as professional risk managers (analogous to the accounting skills expected by audit committees), all board members will increasingly be

expected to understand the fundamentals of risk at the very least, and to keep up with key developments and controversies. Both director training and insights from external advisors may be useful in keeping such skills up to date.

- **Put in more time and energy:** none of the above comes without significant additional work, and unfortunately risk and compensation committee members do not have the luxury of trading off their existing responsibilities. With work loads approaching – perhaps even exceeding – those of audit committees, it may become harder to recruit candidates for these roles; compensation committees may find that one of their most important tasks will be to update the compensation arrangements for directors themselves. Mitigating some of this burden will be the assistance of outside advisors (i.e., experts in risk or compensation, as appropriate), though the regulator stresses that such advice be independent of that provided to management.

Even if much of OSFI’s focus on risk is generally not applicable to non-financial firms, its focus on better corporate governance is relevant to all issuers. Shareholders are expecting board members to understand and provide oversight of the business, to put processes and policies in place to ensure thorough deliberation of management proposals and compensation, and to commit the time necessary to fulfill their fiduciary roles.

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