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Bank Board Agendas: 2022

Board and management acting as a team to tackle key issues

As banks focus on the future after an unprecedented recent past, institutional resilience— of strategy, the organisation, and operations—is the foundation for differentiation in this era of radical business transformation.

Banks are reshaping operating and business models by putting customers first and deepening digital engagement. At the same time, they are prioritising the well-being of their workforce as well as a range of environmental, social and governance (ESG) issues. A host of stakeholders are carefully monitoring banks' ESG efforts and, in particular, how banks are following through on their commitments in these areas.

In addition to ESG, boards are expected to continue monitoring management's responses to the industry's risk environment: Increased cyber security risks, including ransomware attacks; economic challenges; a fast-changing (and uncertain) regulatory landscape, and risks. These are matters that will challenge even those boards that are at the top of their game. One director recently observed that many boards are in a once-in-a-lifetime position to help their institutions' management teams seize opportunities to remake their businesses. Drawing on our research, insights, and interactions with bank directors and senior executives, we highlight these key issues for bank boards to keep in mind as they carry out their 2022 agendas:

— **Maintain a relentless focus on understanding the bank's strategy and its future**

— **Embed ESG, including climate risk and diversity, equity, and inclusion (DEI) matters, into regulatory, risk, and strategy discussions**

— **Approach cyber security and data privacy holistically**

— **Know the opportunities and threats of entering the digital assets realm**

— **Champion technology upgrades while attracting and retaining top technology talent in the finance organisation**

— **Step up focus on talent, human capital management, and CEO succession issues**

— **Understand short- and long-term plans for mergers and acquisitions (M&A) as growth, cost optimisation, and customer-service strategies**

— **Monitor risk and compliance issues that accompany fintech alliances**

— **Be wary of "stretch-for-growth'' programs as banks seek to increase revenue and net income**

— **Think strategically about talent and diversity in the boardroom.**

Maintain a relentless focus on understanding the bank's strategy and its future

Given the volatile environment—managing hybrid working, employee activism, digital transformations, and strengthening connections with customers whose behaviors, preferences, and expectations are changing—there is a special need to take time to reassess the board's engagement with management in setting the bank's strategy. We urge a review of the organisation's alignment of culture, values, and strategy. That step demands the identification of specific practices that can drive quality boardroom discussions about strategy and the future.

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Be sure boardroom conversations are, in fact, conversations. Allocate sufficient agenda time to meaningful, two-way discussions between management and the board about forward-looking issues—challenging assumptions and considering scenarios (likely and unlikely)—versus reviewing historical, compliance-related information which, while essential, can crowd-out valuable agenda time. The board's fiduciary role remains oversight, but effective engagement in strategy discussions (which investors expect) increasingly calls for a collaborative mindset. Keep these questions in mind: How can the board help management think through the implications of pressing and potentially existential strategic questions and decisions? Is management providing meaningful materials to the board to prepare directors for critical conversations in order to maximise the board's contribution?

Embed ESG, including climate risk and DEI matters, into regulatory, risk, and strategy discussions

A near certainty in the current regulatory environment is that banks will need to provide detailed and measurable public information about how they are addressing and responding to climate change, DEI, cyber and other ESG risks. Transparency on how these risks are managed is critical to investors, research and ratings firms, activists, employees, customers, and regulators.

Stakeholders are demanding high-quality sustainability information. The board should challenge management to identify material ESG matters, define meaningful metrics, develop a control framework to gather data for reporting and encourage management to obtain assurance over the completeness and accuracy of disclosures. The attention to climate change as a financial risk for banks has become more urgent. One of the most visible risks is the accelerating physical impact of climate change—including the frequency and severity of floods, wildfires, rising sea levels, and drought—impacting, for example, decisions to underwrite mortgages in at-risk areas. Several fundamental questions should be front and center in boardroom conversations about the bank's ESG journey. After determining which ESG issues are material to the bank, assess which of these issues are of strategic significance. How is the company embedding ESG issues into core business activities (strategy, operations, risk management, incentives, and corporate culture) to drive long-term performance? Is there a clear commitment and strong leadership from the top as well as enterprise-wide buy-in? Are the right people leading this effort and is there coordination within the organisation?

Oversight of these risks and opportunities is a significant challenge, involving the full board and multiple board committees. Overlap among committees is to be expected, but any overlap also puts a premium on information sharing and coordination among committees. It also requires that committees have the expertise to oversee the issues delegated to them.

The Hong Kong Monetary Authority issued the Supervisory Policy Manual on Climate Risk Management ("GS-1") on 30 December 2021, providing guidance to authorised institutions ("AIs") on the key elements of climate-related risk management and sets out the HKMA's approach and expectations for reviewing how AIs manage climate related risks. Overall, there are 4 pillars to provide guidance to Ais on the key elements of client related risk management:

— Governance and overview

— Strategy

— Risk management

— Disclosure.

For more information, refer to *Climate Risk Management* (KPMG, January 2022).

Approach cyber security and data privacy holistically

The rapid shifts banks and other companies have made during the pandemic to keep their businesses up and running—hybrid work arrangements, increased reliance on online platforms, outsourcing certain operations, and other tactics—have been a boon to organised crime, hacktivists, and nation states. Cyber attacks and ransomware demands highlight the far-reaching implications and threats caused by these shifts, including more outsourcing activities. Boards have made strides in monitoring management's cyber security effectiveness. There are ongoing efforts to enhance information technology and cyber- deterrence capabilities within banks' operational departments—as well as on boards and relevant committees. Despite these efforts, the acceleration of digital strategies, hybrid work models, increased regulatory scrutiny of data privacy, and the growing sophistication of cyber attackers all point to the continued cyber security challenge ahead.

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Data governance includes compliance with privacy laws and regulations that govern how personal data—from customers, employees, or vendors—is processed, stored, collected, and used. Data governance also includes the company's policies and protocols regarding data ethics—in particular, managing the tension between how the company may use customer data in a legally permissible way and customer expectations as to how their data will be used. Managing this tension poses significant reputation and trust risks for banks and represents a critical challenge for leadership.

To oversee cyber security and data governance more holistically:

— Insist on a data governance framework that makes clear how and what data is being collected, stored, managed, and used, and who makes decisions regarding these issues.

— Clarify which business leaders are responsible for data governance across the enterprise.

— Reassess how the board—through its committee structure—assigns and coordinates oversight responsibility for cyber security and data governance frameworks, including privacy, ethics, and hygiene.

Know the opportunities and threats of entering the digital assets realm

While digital assets hold the promise of helping reduce the existing friction in the payments landscape, there is much for management and boards to learn about these types of assets.

The challenge for traditional banks and their boards is getting up to speed on the risk and opportunities of entering into the digital assets realm in order to attract and retain customers interested in dealing with the assets and "differentiate themselves from competitors and find new sources of noninterest income."[1]

Boards should have a clear understanding of how management plans to establish the necessary infrastructure to support facilitation of transactions in these assets, thus keeping existing customers who are seeking investments in digital assets—and perhaps attracting new customers with similar interests.

While becoming involved in digital assets may enhance a bank's reputation, boards must understand the down-side risks as well as the growth potential. Candor about the current capabilities (and potential shortcomings) of the company's digital assets team will be critical. Boards will need to become educated about the assets in order to ask appropriate questions.

Champion technology upgrades while attracting and retaining technology talent in the finance organisation

The acceleration of digital strategies, expanded service offerings, new data requirements (ESG), and transformations that many banks are undertaking are impacting finance organisations and presenting important opportunities for finance to reinvent itself and add greater value to the business. As audit and risk committees (and ultimately, the board) help guide finance's progress in this area, we suggest a few areas of focus:

— Press management to assess and report regularly on the bank's technology talent. The talent issue remains challenging in the current labor-constrained environment.

— Does expertise exist in-house or would it make sense to bring in consultants or outsource (with the proper risk controls) some elements of new technology?

— Does management understand the impact on internal controls over financial reporting that any new technologies might have?

— Recognising that much of finance's work involves data gathering, boards should discuss with management the organisation's plans to leverage robotics and cloud technologies to automate as many manual activities as possible, reduce costs, and improve efficiencies.

— How is the finance function using data analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital?

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[1] "Blockchain and Banking: Opportunities and Risks With Digital Assets," Bank Director, September 14, 2021

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Understand short- and long-term plans for mergers and acquisitions (M&A) as growth, cost optimisation, and customer-service strategies

Banks increasingly are turning to M&A not only as a growth strategy, but also as a way to create scale, enhance customer-service programs, optimise cost-reduction plans, and acquire technology capabilities they would otherwise be hard-pressed to achieve. As with any strategic initiative, M&As can have both upsides and downsides, which puts pressure on boards to gain comfort that such a move is accretive in both the immediate and longer term.

Over the past year, there are significant increase in the numbers of M&A deals in Hong Kong and China market. According to research, there were a total of 2,381 deals completed in Hong Kong and China in 2021, which is the most since records began in 2006.[2] And while bank deals garner headlines, they also can create downside risk without comprehensive due diligence.

With the increased focus on M&A as a strategy, there are unique operational accounting and control matters that the audit committee and the overall board should be focused on, such as valuations of acquired assets and liabilities, the migration of systems and integration of people and processes. An emerging area of due diligence is understanding the acquiree's ESG strategy and how differences, if any, might impact the combined organisation. In our view, boards and management teams will often benefit by having an independent third-party assist with credit reviews and valuation before committing to a deal.

Monitor risk and compliance issues that accompany fintech alliances

As acquisitions of, and alliances with, financial technology firms have accelerated, banks have stepped up measures relating to internal controls that affect financial reporting, security, and data privacy, among others. Results, frankly, have been mixed.

In the case of alliances or joint ventures with fintechs, bank board members should inquire about cultural differences between the bank and its fintech alliances that could lead to differing perceptions of risk and compliance. Additionally, we recommend the board request specific and routine information to monitor whether fintechs are maintaining acceptable controls, including whether the fintechs are outsourcing a bank's work.

When outsiders become insiders through alliances, management of the control environment moves high on the watch list at the board level. As the bedrock of any bank, controls and security cannot be an afterthought.

Any slip-up with fintechs in this regard raises broader questions of overall readiness by banks and their boards for crisis prevention and readiness. Crisis prevention goes hand-in-hand with good risk management—identifying and anticipating risks and implementing a system of reporting and controls to help prevent or mitigate the impact of such risk events.

We're clearly seeing an increased focus by boards on key operational risks across the organisation. Has the company experienced any control failures after a fintech alliance, and if so, what were the root causes?

Periodically reassess the clarity and appropriateness of board and committee risk oversight responsibilities related to fintech alliances—being mindful to not overload the audit committee's agenda, and recognising the importance of good communication and coordination among committees.

Be wary of "stretch-for-growth'' programs as banks seek to increase revenue and net income

Recently, in order to boost the net income, some banks have implemented strategies to drive down their provision expense, which cannot be sustained as a primary growth factor. Not surprisingly, the temptation to improve income by stretching for growth may be a real risk factor for some banks.

Boards must be wary that some banks could be facing pressures to make riskier choices to achieve growth and income. One form of pressure might be calls to waive certain covenants in loan underwriting as a means to boost results. Another may be to invest excess liquidity in higher risk investments to improve net interest income and/or net interest margin. The board should probe management about such maneuvers or pressures. What measures are in place to deal with such pressures if they arise? What guardrails are in place to monitor and assess growth initiatives? How well defined are rules for management to report on any changes to underwriting and investment standards?

[2]"China and Hong Kong M&A Trends report FY 2021,'' Mergermarket, January 2022

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Think strategically about talent and diversity in the boardroom

Boards, investors, regulators, and other stakeholders are increasingly focused on the alignment of board composition with the company's strategy—with diversity issues front and center. Indeed, the increased level of investor engagement on this issue highlights investor frustration over the slow pace of change in boardrooms and points to the central challenge with board composition: a changing business and risk landscape. Addressing competitive threats requires a proactive approach to board building and board diversity—of skills, experience, thinking, gender, and race/ethnicity.

As part of the board's self-assessment, it should ask: What skills, knowledge, or representation does our board need, and what steps are we taking to search for the person who embodies these characteristics?

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