On the 2023 bank board agenda

Board Leadership Center (India)

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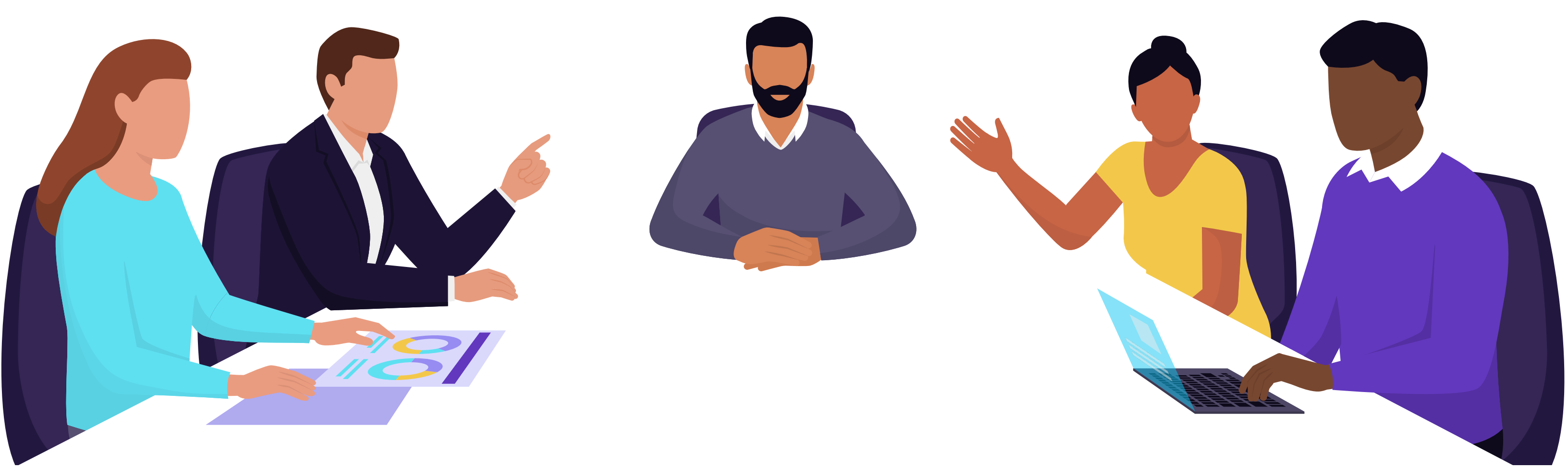
Bank boards will experience an array of challenges in the year ahead – including global economic volatility, stress in global banking sector, rising interest rates, conflicts between countries, cyber security risks, prominence of fintech challengers, regulatory and enforcement risks, and right talent availability.

The business and risk environment has changed dramatically over the past year, with greater geopolitical instability, surging inflation, and the prospect of a global recession added to the mix of macroeconomic risks banking companies face in 2023. The increasing complexity and fusion of risks unfolding simultaneously, and the increased interconnectedness of these risks up the ante for bank boards to have holistic risk management and oversight processes.

In this volatile operating environment, demands from employees, regulators, investors, and other stakeholders for greater transparency and disclosure—particularly around capital and funding profile, portfolio health, cybersecurity, climate, and other environmental, social, and governance (ESG) risks—will continue to intensify.

Drawing on insights from our interactions with directors and business leaders, we highlight eight topics to keep in mind as boards consider and carry out their 2023 agendas:

- Addressing geopolitical, economic risks and uncertainty
- Build and maintain third party eco-system and resilience
- Reassess the board's committee structure and risk oversight responsibilities
- Keep ESG, including climate risk and DEI, embedded in risk and strategy discussions
- Approach cybersecurity, data privacy, and artificial intelligence (AI) holistically as data governance
- Make talent, human capital management (HCM), and CEO succession a priority
- Prioritising customer experience and driving digital transformation
- Think strategically about talent, expertise, and diversity in the boardroom



1 Addressing geopolitical, economic risks and uncertainty

Heading into 2023, turmoil in the global banking sector, developments in the war in Ukraine, tensions with neighbouring countries, supply chain disruptions, global energy shortages, cybersecurity, inflation, rising interest rates, market volatility, trade tensions, and the risk of a global recession will continue to drive global volatility and uncertainty.

This environment will call for continual updating of the bank's risk profile and more scenario planning, stress-testing strategic assumptions, and analysing downside scenarios. Leaders will need to assess the speed at which risks are evolving, their interconnectedness, the potential for multiple crises at the same time.

Oversee management's reassessment of the strategy and processes for identifying and managing these risks and their impact on the bank.

- Is there an effective process to monitor changes in the external environment and provide early warning that adjustments to strategy might be necessary?
- Is the bank prepared to weather an economic downturn?
- Is there a ripple effect from global banking turmoil ?

The threat of inflation has led the Reserve Bank of India to increase interest rates six times since May of last year. This could result in making fixed deposits attractive for investors, while putting pressure on the borrowers on account of additional interest cost. Additionally, rising interest rates, inflation and the likelihood of a recession intuitively increase the risk of credit losses for banks. This highlights the need to assess exposure to variable rate loans, monitor migration of loans across delinquency and credit risk rating categories — looking for early warning signs of credit deterioration, assessing concentrations in higher risk portfolios such as real estate and re-examining whether underwriting criteria and loan pricing are appropriately calibrated to current economic conditions. Considering, the volatility in the stock markets, banks should also assess their credit exposure against pledged securities. This would also require oversight by the audit committee to determine whether the bank's expected credit loss estimation methodology is appropriately capturing credit risk through the model and/or qualitative components of the methodology.

The board should help management keep sight of how the big picture is changing—connecting dots, thinking differently, and staying agile and alert to what's happening in the world. Disruption, strategy, and risk should be hardwired together in boardroom discussions.

Challenge and question management's crisis response plans.

Are they robust, actively tested or war-gamed, and updated as needed?

Do they include communications protocols to keep the board apprised of events and the bank's should help to determine when/if to disclose matters internally and/or externally?

2 Build and maintain third party eco-system and resilience

India has been at the forefront of open banking initiatives wherein both the regulator and the market have collaborated for development of this space. Reserve Bank of India (RBI) has set up Regulatory Sandbox and Reserve Bank Innovation Hub to give guidance and encourage the market. Further, the banks are now partnering with a number of third-party service providers and fintech players for services such as know your customer (KYC) checks, database checks, digital signatures, document execution, cloud storage, etc. While the open banking initiatives present great opportunities, it also exposes the bank to key risks such as customer privacy, data protection, cyber vulnerabilities, etc. Identifying the right partner and establishing the best controls are imperative for building a robust third-party eco-system and resilience. While the RBI has issued outsourcing guidelines and digital lending guidelines, the banks are experimenting with criteria for evaluation and selection of third-party service providers / fintech players, as there are no widely accepted industry standards.

Using third parties effectively means that your outsiders are your insiders because businesses have outsourced. Many organisations are unaware of hidden backdoor entry points to critical internal and client data that criminals seek to exploit. The processes (or lack thereof) management employs to counter these relentless attacks and probes, demand that boards consistently ask assessment questions, like those provided here, of management teams.

- When were your vendors last evaluated by you on their risk protocols, especially if those vendors are using cloud-based technologies to store the bank's information?
- When did your organisation examine the risk evaluation parameters used in selecting third parties for such high-risk functions?
- Looking at your bank's stated strategic outsourcing risk profile, are you, as board members, comfortable that all third parties your bank uses align with that profile?
- Does your bank have a documented vendor-risk profile?
- Is the bank relying too heavily on one vendor? Should more vendors be used for specific operations provided they are properly vetted?

Bank boards should help ensure that management's projects to build and maintain third-party eco-system and resilience are carried out effectively, such as:

- Assessing third party risks and vulnerabilities
- Partnering with the right service provider and diversifying the third-party base
- Improving third-party cybersecurity to enhance resilience from disruption and reduce the risk of data breaches
- Developing plans to address future third party disruptions.

3 Reassess the board's committee structure and risk oversight responsibilities

The increasing complexity and fusion of risks unfolding simultaneously requires a more holistic approach to risk management and oversight. At the same time, investors, regulators, ESG rating firms, and other stakeholders are demanding higher-quality disclosures—particularly on portfolio health, frauds, climate, cybersecurity, and other ESG risks—and about how boards and their committees oversee the management of these risks.

The challenge for boards is to clearly define the risk oversight responsibilities of each standing committee, identify any overlap, and implement committee structure and governance processes that facilitate information sharing and coordination among committees. While board committee structure and oversight responsibilities are largely mandated by the regulators, we recommend few areas of focus:

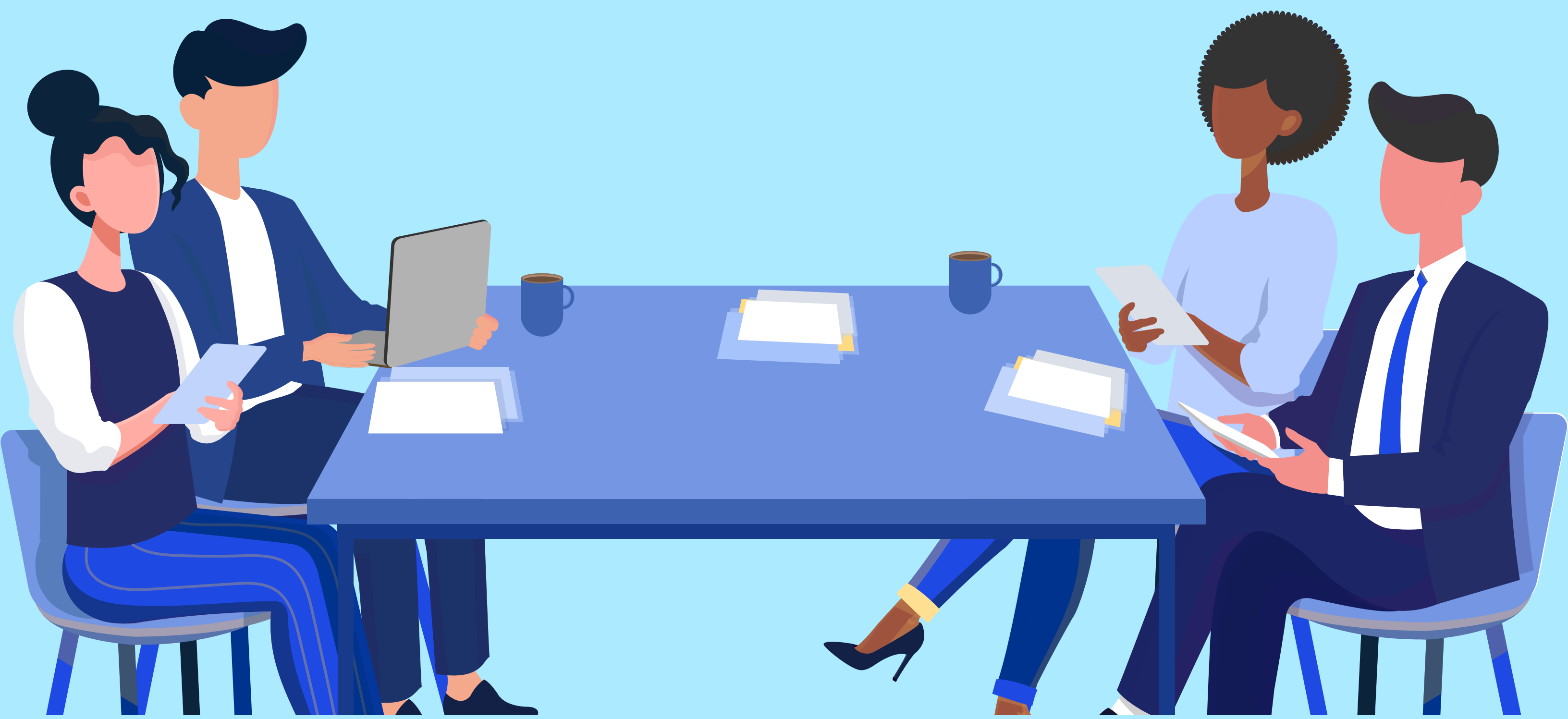
Do the board and standing committees have the time and members with the experience and skill sets necessary to oversee areas of risk such as cybersecurity, data privacy, supply chain, geopolitical, climate, and other ESG-related risks as well as the adequacy of management's overall ERM system and processes?

Is there a need for new directors with skill sets or experience to help the board oversee specific risks?

Is there a need to hire outside specialists who have experience in dealing with certain risks?

Is there continuing education about the rise/ expansion of new risks for the board and management?

Identify risks for which multiple committees have oversight responsibilities, and clearly delineate the responsibilities of each committee. For example, in the oversight of climate and other ESG risks, the nom/gov (or sustainability committee), compensation, and audit committees likely each have some oversight responsibilities. And where cybersecurity oversight resides in a technology committee (or other committee), the audit committee may also have certain responsibilities. To oversee risk effectively when two or three committees are involved, boards need to think differently about how to coordinate committee activities. For example, some boards have established a board-level ESG committee, composed of members of the board's existing standing committees, focused on ESG disclosures and issues.



4 Keep ESG, including climate risk and DEI, embedded in risk and strategy discussions

How companies address climate change, DEI, and other ESG issues is viewed by investors, research and ratings firms, activists, employees, customers, and regulators as fundamental to the business and critical to long-term value creation.

In line with major economies, India has already made sustainability disclosures for publicly traded companies and developed ESG ratings for both companies and broader markets. Further, report of the survey on 'climate risk and sustainable finance' by RBI dated 27 Jul 2022, highlighted the need for following actions:

- Governance: Mechanism at either the board or top management level for overseeing and scaling up initiatives relating to climate risk and sustainability. Include KPIs on climate risk, sustainability and ESG as a part of the performance evaluation of the top management
- Risk management: Grasp the physical, transition and liability risks associated with climate risk and also actively start managing them to make their loan and investment portfolios more resilient to such risks. Develop strategy for managing climate risk and integrating it into their risk management framework
- Climate-related financial disclosures: Banks need to align their climate-related financial disclosures with an internationally accepted framework to improve the comparability and consistency of the disclosures with their counterparts globally
- Opportunities from transition to a green future: Banks could consider mobilising new capital to scale up green lending and investment or set a target for incremental lending and investment for sustainable finance
- Human resources (HR) and capacity building: Capacity building of their staff on climate risk, ESG and sustainable finance. Dedicated resources to successfully tap the opportunities arising from climate change, sustainable finance and the growing focus on ESG.
- Moving towards a low-carbon environment in banking operations: Strategy to reduce emissions from their own operations. In line with India's commitment at the COP26 summit, banks may also consider working on a timeline to move towards net-zero emissions.

Demands for higher-quality climate and other ESG disclosures should be prompting boards and management teams to reassess and adjust their governance and oversight structure relating to climate and other ESG risks—and to monitor RBI / SEBI / global regulatory developments in these areas. Further, bank boards should lay down framework for clear goals, metrics as well data sources for monitoring purposes.

5 Approach cybersecurity, data privacy, and AI holistically as data governance

Cybersecurity threats are dynamic and related impacts continue to intensify. The acceleration of AI and digital strategies, the increasing sophistication of hacking and ransomware attacks, and the lack of definition for lines of responsibility—among users, companies, vendors, and government agencies—have elevated cybersecurity risk and its place on board and committee agendas.

A holistic approach to cybersecurity and data governance is a fundamental principle as banks seek to function as effectively as possible in the current environment. It is essential that banks plan for how they should organise critical processes during the lifecycle of a cyber incident and establish guiding principles that define responses.

The ultimate aim is to enable bank management teams to respond quickly and appropriately in order to limit risks and exposures to their organisations and customers. A plan also is intended to enhance existing company policies that protect business and customer data.

A holistic response is predicated on these key elements of resilience: preparation, prevention, detection, mitigation, and recovery—and we further recommend establishing specific teams that create checklists along these key elements of resilience. When an attack occurs, having a written plan with specific tasks could help teams focus during a frenzied time.

While data governance overlaps with cybersecurity, it's broader and includes compliance with industry- specific privacy laws and regulations as well as privacy laws and regulations that govern how personal data—from customers, employees, or vendors—is processed, stored, collected, used, shared, and disposed. Data governance also includes 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 companies and represents a critical challenge for leadership.

To oversee cybersecurity and data governance more holistically:

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

Clarify which business leaders are responsible for data governance across the enterprise— including the roles of the chief product officer, chief information officer, chief information security officer, chief data officer, and chief compliance officer

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

An increasingly critical area of data governance is the company's use of AI to analyse data as part of the company's decision-making process. Boards should understand the process for how AI is developed and deployed. What are the most critical AI systems and processes the company has deployed? To what extent is bias—conscious or unconscious—built into the strategy, development, algorithms, employment, and outcomes of AI-enabled processes? What regulatory compliance and reputational risks are posed by the company's use of AI, particularly given the global regulatory focus on the need for corporate governance processes to address AI-related risks, such as bias and privacy? How is management mitigating these risks?

6 Make talent, HCM, and CEO succession a priority

While the most dramatic change in the employee value proposition took place during the pandemic, employee empowerment has not abated, and employees are demanding fair pay and benefits, work- life balance, including flexibility; interesting work; and an opportunity to advance. They also want to work for a company whose values—including commitment to DEI and a range of ESG issues—align with their own.

In 2023, we expect continued scrutiny of how companies are adjusting their talent development strategies to meet the challenge of finding, developing, and retaining talent amid a competitive labour market. Does the board have a good understanding of the company's talent strategy and its alignment with the bank's broader strategy and forecast needs for the short and long term? What are the challenges in keeping key roles filled with engaged employees? Which talent categories are in short supply and how will the company successfully compete for this talent? Does the talent strategy reflect a commitment to DEI at all levels? As millennials and younger employees join the workforce in large numbers, is the company positioned to attract, develop, and retain top talent at all levels?

Pivotal to all of this is having the right CEO in place to drive culture and strategy, navigate risk, and create long-term value for the enterprise. The board should help ensure that the company is prepared for a CEO change—whether planned or unplanned, on an emergency interim basis or permanent. CEO succession planning is a dynamic, ongoing process, and the board should always be focused on developing a pipeline of C-suite and potential CEO candidates.

Further, with the Reserve Bank of India capping the maximum tenure for the MD & CEO of commercial banks, the board will require to assess and lay down a suitable succession plan for key roles, including that of MD & CEO.

7 Prioritising customer experience and driving digital transformation

Digital disruption has changed the customer expectations regarding banking services and products. This has brought the importance of enhancing customer experience and journey to the forefront of the bank’s product strategy and service delivery. The board should support long term transformations and innovative strategies that focus on overall experience of customer which includes everything from brand messaging to marketing and customer onboarding to customer servicing journey.

Most Indian banks had embarked on transformation of their operations to meet the client expectations. Further, most of them accelerated digital transformation of their services, including modernisation of core banking systems. However, the evolving models of fintech partnerships, leveraging of central utilities, etc. would require further changes to the existing technology infrastructure at these banks.

Some of the key focus areas of the board could be the following:

- Developing customer first strategy and integrating across the bank
- Untapped value due to poor customer experience
- Creating engaging future customer experiences
- Modernisation of existing technology and introduction of new technologies into business and customers
- Bridging the gap between the board and marketing / product functions

8 Think strategically about talent, expertise, and diversity in the boardroom

Boards, investors, regulators, and other stakeholders are increasingly focused on the alignment of board composition—particularly director expertise and diversity—bank in lieu the company's strategy.

Indeed, the increased level of investor engagement on this issue points to the central challenge with board composition: Having directors with experience in key functional areas critical to the business while also having deep industry experience and an understanding of the company's strategy and the risks to the strategy. It is important to recognise that many boards will not have 'experts' in all the functional areas such as cybersecurity, climate, HCM, etc., and may need to engage outside experts.

Developing and maintaining a high-performing board that adds value requires a proactive approach to board-building and diversity—of skills, experience, thinking, gender, and race/ethnicity. While determining the company's current and future needs is the starting point for board composition, there is a broad range of board composition issues that require board focus and leadership—including succession planning for directors as well as board leaders (the lead director and committee chairs), director recruitment, director tenure, diversity, board and individual director evaluations, and removal of underperforming directors. Boards need to 'tell their story' about the composition, skill sets, leadership, and functioning of the board and its committees.

Board composition, diversity, and renewal should remain a key area of board focus in 2023, as a topic for communications with the company's institutional investors and other stakeholders, enhanced disclosure in the company's proxy, and most fundamentally positioning the board strategically for the future.

In conclusion

While Indian banks seem to be largely insulated from the global banking turmoil, in a highly interconnected world economy, it will be prudent for the bank boards to ensure that the management is capable of managing a potential banking crisis by proactively assessing the early warnings, risk triggers and also putting in place a robust crisis response mechanism. Bank boards should also assess the third party ecosystem, risk management mechanisms and their resilience. Board may also take steps to clearly outline accountability of various risk taxonomies across the board level committees and ensure integrated view of the risks. With ESG and diversity gaining prominence, the bank boards should consider these aspects in their strategy as well as risk deliberations. As banks have significantly progressed in their digital journey and continue to invest in providing superior digital experience, it will be important for the board to evaluate cyber security, data governance and privacy holistically to address the risks appropriately. The boards should also prioritise talent management initiatives as well as introducing board members to the right expertise or seeking help from external domain experts.

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