Corporate Governance of Financial Institutions

Thought Starter

BIAC appreciates the opportunity to contribute to discussions on corporate governance of financial institutions. We are still learning lessons and drawing conclusions from the financial crisis, now nearly 8 years ago. The complexity of today’s financial markets has meant that we still see disputes about the cause and even the effects of the crisis, and this has kept us from reaching consensus on policy prescriptions and remedies to prevent a future crisis. We welcome the fact that the OECD and the FSB are taking the initiative and asking important questions about the governance of banks and other financial institutions.

BIAC has been actively involved in contributing to the discussions on the update of the OECD Corporate Governance Principles. The focus now needs to be on effective and balanced implementation around the world. At the same time, we would like to recall that while many of the overarching recommendations included in the Principles are relevant to banks and financial institutions, not all the specifics may be readily applicable to them. This should be taken into account in the FSB peer review. The following examples illustrate some of the key differences:

- Many jurisdictions around the world today impose a **multiple-fiduciary duty on bank directors** – to shareholders, to depositors and to society at large. After all, banks have millions of depositors who have entrusted savings to their safekeeping, and if a retail bank ceases to function there is a high risk of social disorder and hardship. In addition, implicit government guarantees and deposit protection measures mean taxpayers are exposed to the possible failure of a financial institution as well. All of this complicates the situation in which their directors find themselves and has no detailed place in the current Principles.

- Little is mentioned in the Principles about risk and risk oversight by the board of directors. The Principles suggest that disclosure about the system for monitoring and managing risk is ‘increasingly regarded as good practice’ and that ‘The Board should demonstrate a leadership role to ensure that an effective means of risk oversight is in place.’ These are useful recommendations for an industrial company, but they might be too simple and stripped-down for a large financial institution, let alone a sophisticated G-SIFI. There is little in the Principles about risk governance as the FSB or we would...
define it, and there is nothing in the Principles about risk appetite, what this means, and how the board might be involved.

- Also, the Principles are **rather tepid in their recommendation for audit and risk committees.** The Principles say that ‘boards should consider setting up specialized committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company’s size and risk profile, also in respect to risk management and remuneration.’ It is understandable that the Principles strike a cautious note here, as the horizon they scan must cover everything from small listed companies to large multinational institutions. In our view, financial institutions **should** have audit and risk committees.

- The Principles mention the **market for corporate control** as a way to ensure accountability for under-performing managements. Yet in most cases, banks are not subject to the discipline of takeovers. Banks are highly regulated entities, and cannot simply be bought up by a risk-hungry hedge fund or combined with another bank without regulatory approvals.

- The Principles suggest best practice for **director nominations.** They talk about the need for a ‘balanced and qualified board’ and the role of nomination committees. Yet we acknowledge that many financial institutions are not totally free in the selection of their directors. As part of good governance, key criteria for the nominations committee of boards should include among other issues skills and experience balance, and quality, and have regard for the fit and proper test as appropriate.

- Finally, equity-holders – while they are the residual claimants and owners of a bank – and while they contribute to regulatory capital - contribute an increasingly small amount to a large bank’s balance sheet. Shareholders contribute perhaps just a few percent to the balance sheet of a globally significant bank, yet the Principles say nothing about bondholders, beyond the fact that their contractual rights should be respected and their role and rights as creditors at large when firms near bankruptcy. For banks, and other financial institutions a more detailed description of the role of creditors beyond what the Principles provide would be helpful.

Strong governance at banks starts with strong, knowledgeable and empowered boards, with independent, knowledgeable and empowered audit and risk committees, all supported by aware and engaged investors. In addition, quality audits are highly dependent on a high quality board and management.

Yet there are challenges with each one of these fundamental points:

- Those strong, knowledgeable and empowered **boards are facing a number of challenges**, as it is the case for senior employees. Take board tenure as just one indication. In the UK, for example, HALF of all bank boards are composed of directors who have been there for 3 years or less and have to face annual reelection. Sufficient time is needed to build trust in the CEO/board dynamic and this is hard to achieve if there is high turnover on boards.

- On top of this, **CEO tenure** is also shrinking. Outside, non-executive directors now often serve the bank for longer periods than the CEO. These trends should be of concern to regulators and to the
public at large. Take, for example, a bank’s need to invest in IT and IT infrastructure. If a CEO is there for only 4-5 years, there should be incentives to invest even when there are only long-term payoffs. There is also concern about the attractiveness of the non-executive role at financial institutions: The accountability regimes in many countries today make the role increasingly difficult, with the promise of regulatory second-guessing, back-breaking fines and penalties, irreversible damage to reputation and even jail time. Regulators should deal with these concerns.

- There are still many banks that prefer sitting CEOs join their board (that is, CEOs of non-banks, with no FI skills, few risk skills), or who prefer directors that appear impressive to the business community, whether or not they have the right skills. The application of the fit and proper test could prove helpful for assessing suitability.

- There is further concern that strict rules on independence mean that directors with insufficient connection to the business could be privileged over those who may be less independent, but who know the business intimately. Strict independence rules for bank boards can therefore often be counter-productive.

- At the same time, it is important to strike the right balance between independence and competence. While directors need to demonstrate leadership, oversight and objective thought, experience, skills, and expertise are also key, and there is a role for non-executive directors on boards who are experts on specific issues, such as cyber-security, or interest-rate risk, or branch management, or China. At the same time, care should be taken that the Board does not only become a committee of experts.

- For audit and risk committees: We increasingly see bank audit committees so overwhelmed by compliance work and checking off boxes that they have little time to focus on emerging risks, or systemic risks, or think about the bigger picture, such as for example the impact of a low-interest environment on the sustainability of financial institutions’ business models. With respect to executive remuneration, one should investigate the effectiveness of recent regulatory intervention (probably at its toughest in the EU) to limit the ratio of variable to fixed remuneration, to change the balance between cash and shares, to increase the deferral period and require banks to exercise clawback of variable remuneration when this is justified.

- Finally, the need to focus on engaged investors: The question is how do we get investors to be more long-term oriented? Any governance code for banks has to pose hard questions about the governance of investors themselves. Stewardship codes have not done much to get shareholders to look at risk-taking within their own portfolios. The very nature of the limited downside and unlimited upside of equity could mean that shareholders and banks have misaligned incentives. It would therefore be of interest to look at the role that creditors might play, given their lack of an upside. Creditors therefore have a strong preference for stability. When we look at cases where creditors engage with listed companies on their governance, they naturally advocate for less risk-taking and policies that support long-term concern. We call this Bondholder Stabilism.

- With respect to audits, any good questionnaire or set of governance principles should ask what kind of audit/assurance financial institutions require, recognizing that the objective of a financial statement audit is focused on providing assurance that financial statements are free from material
misstatement. As most of a bank’s balance sheet is in fact contributed by both depositors and creditors, they need more and different information than shareholders. They need more precise and more comparable information, about cash flow, about the ‘fair value’ of the assets on a bank’s balance sheet, and much else besides. Creditors may also want to know the expected amount of support the bank might receive from the government and ring-fencing. Additionally, there is growing interest by investors and the public at large in non-financial reporting and societal aspects of the operations of financial institutions. Good governance implies that financial institutions should give consideration to the reporting and disclosure of certain information beyond what is required in financial statements, and the level of assurance that might be appropriate. Due to a bank’s reliance on technology, and increasing risks related to cybersecurity, it should be considered to have the report by the risk management committee audited by industry experts that do not have to be the auditors.

Finally, a note about the **importance of appropriate governance arrangements and culture**: Eight years on from the financial crisis, one can witness cases of weakening of governance teams due to cost pressures on resources. This is concerning as the attention to the sustainability of governance should not only be a result of a crisis but an intensive permanent effort.