

9 January 2015

Secretariat of the Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland

Submission on revised Corporate Governance Principles for Banks

Ernst & Young Global Limited (EY), the central coordinating entity of the Ernst & Young organization, welcomes the opportunity to offer its views on the October 2014 Consultative Document on the Basel Committee on Banking Supervision's (BCBS) *Corporate Governance Principles for Banks* (BCBS Principles). EY views good corporate governance as an essential element for well-functioning capital markets. Public and investor trust in market participants is greatly enhanced when credible governance structures exist and function effectively. We believe this is particularly true for banks, due to their significant public interest role. We have seen governance expectations for banks increase along with new and elevated regulatory requirements that are a catalyst for long-term structural and organizational change.

As we reviewed the BCBS Principles, we were reminded that it is always challenging to develop a universally applicable yet sufficiently challenging corporate governance benchmark. To this end, we encourage the BCBS to retain its principles-based approach, which sets expectations appropriately high while enabling principles to be tailored for different environments. Indeed, a key element of Principle 1 that is central to good governance is the need for the board to periodically review the governance framework to ensure that it remains appropriate as circumstances change. Principles-based policy on governance supports such self-assessments by not suggesting that meeting specific structural and operational requirements alone assures good governance.

Our feedback on the BCBS Principles essentially focuses on what we see as the opportunity for alignment with relevant Financial Stability Board (FSB) reports, and some clarifications to the draft to ensure that the BCBS Principles encourage strong board and management accountability, robust "three lines of defense," clear expectations for subsidiary-level governance and strong audit committees.

Alignment with the Financial Stability Board (FSB)

As an overall comment, we recommend the BCBS consider its proposed revisions to the Principles in the context of the reports published by FSB on risk appetite¹ and risk culture²; these reports outline the differing roles and responsibilities of board and management in important areas of risk governance, and those of the various elements of the three lines of defense. By focusing heavily on the role of the board of directors, the proposed revisions to the BCBS Principles could be viewed as downplaying somewhat management's critical roles and responsibilities, as described by the FSB. For instance, the FSB risk

¹ Financial Stability Board, [Principles for an Effective Risk Appetite Framework](#) (Basel: Financial Stability Board, 2013).

² Financial Stability Board, [Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture](#) (Basel: Financial Stability Board, 2014)

appetite principles address, in some detail, its expectations for business line management being primarily responsible for managing the full array of risks in the businesses. Inasmuch as embedding these first-line-of-defense responsibilities is still evolving in the industry, we believe the BCBS could reinforce the FSB's expectations in this regard, including as they relate to the relationships of the three lines of defense to one another, to ensuring that risk-appetite considerations inform day-to-day decision making, and to ensuring appropriate oversight and control of risk. The BCBS Principles can play a powerful role in reinforcing the FSB's work.

Need for further clarity

Overall, we believe the BCBS Principles cover the topic area effectively, and with the right balance between principles and detail. There are, however, some areas where we believe the proposed language could be clarified or expanded to ensure banks interpret and implement the BCBS Principles effectively and with the degree of rigor intended by the BCBS.

These areas include:

Strong accountability

No governance framework can be effective without clarity of roles and responsibilities, and clear lines of accountability. Where roles become blurred, accountability can be weakened. It is vital that the BCBS Principles outline a sufficiently high standard for the role of the board, but do so in a way that does not obscure or undermine senior management's accountability.

There are certain places where we believe the draft BCBS Principles might unintentionally weaken board and management accountability:

- **Well-defined roles for the board and management.** The general set of responsibilities listed in paragraphs 2 and 23 are a good framework within which to highlight the specific responsibilities of board *vis-a-vis* management. The wording in paragraph 23 is critical since it goes into more depth than paragraph 2. In a few areas in paragraph 23, we believe the BCBS articulates the board's role in a way that could be confused with management's, and we believe further clarity is needed, e.g.:
 - The proposed revisions to the BCBS Principles state the board should *establish* the bank's objectives and strategy, and *establish* the bank's culture and values. While the board has a critical role in both areas, management has a central role, too. Management defines the strategy; the board influences, challenges and ultimately approves it or not. Similarly, boards play an important role in the bank's culture, but so, too, does management. We recommend revising the language to align with the way the BCBS Principles outline the board's role in the firm's risk appetite (bullet 4).
 - Under the section on risk appetite, management and control, in paragraph 32, the BCBS Principles suggest "the board should clearly outline actions to be taken when stated risk limits are breached." Certainly, the board should approve the framework of actions to be taken, but in practice, management proposes the policy approach and the board challenges and ultimately approves it or not.

In this context, we encourage the BCBS to more clearly delineate the various responsibilities of the board and management. Footnote 10 in the BCBS Principles describes the BCBS's view of what "to ensure" means, but, in our view, this definition should be further clarified.

Separately, on selecting management, we believe the phrasing used in paragraph 43 is preferable to the language used in the penultimate bullet in paragraph 23 – most importantly, it notes the board has a central role in selecting the CEO, and should be held accountable by its

external stakeholders for the CEO's performance; after all, only the board has the power to hire and fire the CEO.

- **Director independence and expertise.** We believe the section on board qualifications and composition should place more emphasis on the need for a substantial number of board members to be independent. Paragraph 50 notes conflicts of interest, but we encourage the BCBS to more explicitly state the importance of director – and thus board – independence, particularly in a way that captures the need for independence of mind and opinion, as much as independence from financial or other relationships. Board independence is an essential ingredient in board and management accountability, and should be a prerequisite for appropriately staffing the board and its committees.

In this context, in paragraph 47, the BCBS Principles could stress more explicitly than currently the necessity for ample sector expertise in the board, which was very limited pre-crisis. Technology and consumer-facing/marketing expertise is also increasingly important.

- **Clear senior management accountability.** The board plays an essential role in holding senior management to account for meeting their goals and performing the broad array of their responsibilities, as outlined in paragraph 44. The BCBS Principles could helpfully articulate that, beyond enumerating the consequences for management of not meeting the board's performance expectations, the board is responsible for acting independently and robustly when management materially underperforms, and doing so in a timely, effective and diligent manner.
- **First-line accountability.** It is essential that the first line of the three lines of defense is fully aware of its responsibilities and held accountable for its performance. The first line is where risk is most often created and where individuals are therefore closest to the specific facts and circumstances involved. Too often, the second line is held to account for control failures that, in practice, should have been considered a failure of the first line. We address this in more detail below, but in the context of accountability, it is important, that the BCBS describe more clearly what constitutes the front-line – in paragraph 11, the BCBS Principles mention simply the business line; in fact, the first line of defense includes business leaders, risk-takers and front-line market- and customer-facing employees and in-business control professionals, such as those in risk, compliance and IT (obviously, these are distinct from the independent second-line functions).

We also believe it is important that the BCBS Principles state that banks need to be clear in stating what the first line is accountable for – too often, their risk and control responsibilities are unclear, too narrowly focused on direct financial risks undertaken by market-facing units and not all the material risks involved in the end-to-end activities of the business in question, or so burdensome that they are impossible to enforce.

- **Importance of evaluating committee responsibilities.** We would also recommend that in paragraph 57, as part of enabling strong board-level oversight, the BCBS Principles highlight the importance of evaluating committee structure and coordination as part of the board's routine effectiveness reviews. The overlap in responsibilities between banks' board committees is increasingly complex, whether it be overseeing aspects of risk, compliance, compensation or technology, and it is important that boards periodically evaluate how effectively the committees collaborate on related responsibilities. It is also important that these committees effectively engage the full board so that all directors are sufficiently abreast of key issues, regardless of their own individual committee assignments.

Robust three lines of defense

We welcome the BCBS's inclusion of the three lines of defense approach. This model is an essential part of a bank's control and risk approach, and if done well we believe can be highly effective. We also welcome the BCBS's Principle 9 (paragraphs 131-138) on compliance – often, the critical role of compliance in the second line is overlooked due the central focus on risk.

We note that bank regulatory guidance is increasingly focused on the need for a robust three lines of defense model, for example, the Heightened Standards issued by the US Office of the Comptroller of the Currency.³ We view this as a positive step, because banks are more likely to fund and staff their risk and control functions appropriately when this is seen as a regulatory imperative.

In considering the way in which the BCBS Principles promote the three lines of defense, we would encourage the BCBS to consider strengthening relevant language to highlight:

- **First-line accountability** (see above).
- **Clarity of roles and responsibilities of various components of the three lines of defense.** While the BCBS Principles should not be prescriptive in describing the three lines of defense structurally, in our view, they should broaden their description of the model as it relates to specific activities (rather than functional units), and whether the activity is first- or second-line in nature irrespective of what organizational unit conducts them. They should also encourage banks to adopt clear roles and responsibilities for the various activities to aid effectiveness. The proposed revisions to the BCBS Principles comment on the risk and compliance functions, yet in compliance there are monitoring and testing activities that are second-line in nature and advisory activities that are more first-line in nature. The activities of other important, largely independent, control and support functions also merit mentioning, such as IT or legal; also, in the context of risk culture, the human-resource function has taken on something of a control role related to aligning incentives with risk (along with the risk management function), while also, of course, partnering with the businesses to attract and retain talent.
- **Front-to-back responsibility.** Paragraph 130 highlights the potentially negative effects of operating in silos. In the context of the three lines of defense, it is essential that the three lines work together, albeit the second and third lines have to remain independent. Increasingly, we are seeing banks consider the robustness of the three lines of defense control structures from front to back and questioning whether it all works in totality. New controllership roles have been established in some banks in this context. The BCBS Principles could usefully highlight the need for a holistic front-to-back approach to controls effectiveness.
- **Appropriate resources, staffing and stature.** The proposed revisions to the BCBS Principles articulate well the requisites for an effective risk management function and chief risk officer (CRO) (Principle 6, paragraphs 103-109). The level of detail, especially in paragraphs 108 and 109, is welcome. The BCBS could also consider providing the same level of detail on compliance and internal audit (e.g., to amplify paragraphs 137 and 141, respectively). Subject to local legal, regulatory and professional requirements, the BCBS Principles should outline the BCBS's expectations for the preferred approach to hiring, firing and evaluating the performance of the chief compliance officer and chief audit executive (as it has for the CRO, in paragraph 109).

³ Office of the Comptroller of the Currency, [*OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations \(Final Rule\)*](#) (Office of the Comptroller of the Currency: Washington, DC, 2014).

Clear expectations for subsidiary-level governance

We welcome the BCBS's inclusion of language on subsidiary-level governance, which is an increased regulatory focus and part of a broader effort to require the establishment of more robust, effectively standalone, units with specific jurisdictions (paragraphs 96-97).

In practice, we have found banks sometimes find it challenging to balance local governance requirements and parent governance (especially in wholly-owned subsidiaries). We recommend the BCBS Principles state how important it is for banks to clearly define as part of their legal-entity policies the expectations for subsidiary governance, especially with respect to the boards and/or risk committees, local senior management and the local risk and compliance organizations, as well as their relationships to enterprise-level governance bodies and functions. These responsibilities are set within the context of the local regulations and requirements, of course.

It is worth noting that the role of a subsidiary board is different to that of a parent-company board. In some areas, it has a critical and comparable role, e.g., in ensuring the subsidiary is operated in a prudent and sound manner. In other areas, it has a conscribed role, e.g., in strategy, risk and compliance, and as the BCBS Principles note, these functions are set within the context of the parent's objectives and approach. In yet other areas, it has no role, e.g., in selecting the local CEO. The subsidiary board's role in financial reporting is greatly influenced by local regulation.

For ease of use, we would recommend the BCBS consolidate its recommendations on subsidiary-level governance into one section, e.g., by bringing together paragraphs 96-97 and 123.

Strong audit committees

We believe effective audit committees are an essential part of a sound corporate governance framework. Effective audit committees help ensure financial reporting integrity by means of their oversight of both the external auditor and management (including the internal auditor and systems of internal controls). Effective audit committees communicate candidly with management and the auditor and foster a corporate culture of discipline, accountability, transparency and sound risk management. Through their oversight role, audit committees offer informed challenges to executive management, internal auditors and external auditors. A number of empirical studies have demonstrated the value of independent audit committees.⁴

We believe audit committees are important for all banks, regardless of size, as integrity in financial reporting, audit and compliance are core to any bank. Therefore, we recommend that BCBS strengthen the language in paragraph 67 to require audit committees for all banks, not just "systemically important banks" or "banks of large size, risk profile or complexity." Subsidiary-bank boards should also consider establishing an audit committee, or at a minimum ensure there is appropriate independent oversight of the subsidiary's financial, audit and internal-control processes. This is particularly important where local regulations require the local entity to generate standalone financial statements. We recognize that there may be situations where a bank or board's size or structure might call for an exception, and in those circumstances a board should explain to shareholders how it is fulfilling its obligations around oversight of financial reporting and disclosure.

⁴ See, e.g., Ghafran, Chaudry and O'Sullivan, Noel, *The Governance Role of Audit Committees: Reviewing a Decade of Evidence*, International Journal of Management Reviews Vol. 15.4: 381-407 (October 2013).

The BCBS's work on corporate governance is important and timely. We would be pleased to discuss our comments with members of the Secretariat of the BCBS. If you wish to do so, please contact Mark Watson, at mark.watson@ey.com or +1 617 305 2217.

Yours sincerely

Ernst + Young Global Limited