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Principles for enhancing corporate governance – Response to the consultative document

Nestor Advisors Ltd is a London-based consultancy focusing exclusively on corporate governance. Our most important client base is the financial sector, and we have worked with the leaders of four of the top-20 Eurozone banks assisting them in improving corporate governance and decision-making in their institutions. We have also helped transform the governance of large EMEA banks that are among the top five in their respective markets and have conducted in-depth governance studies of the largest 25 European banks. Nestor Advisors is grateful for the opportunity to comment on the draft *Principles for enhancing corporate governance* (the “Principles”) on the basis of our experience and insights into how bank boards function. We hope that our comments will contribute to a robust set of guidelines that may assist banking organisations in their ongoing quest to address the corporate governance failings that became apparent in the 2007-2009 banking crisis.

Overall, we find the Principles to be of high quality. For the first time, they bring to the drawing board a fresh perspective to governance issues which are particularly relevant to banks. This includes the new focus on the board’s responsibility for risk oversight and strategic appetite matters combined with the need for a strong and independent group risk function to address past risk management failures. Also, the new emphasis on group governance issues and the imperatives of “know/understand-your-structure” is much needed in an era of globalised markets and institutions, while the weight given to director competence is key for enhancing the board’s ability to direct and control an increasingly complex business. Likewise, the requirement for the board to have a keen eye for conflicts of interest and adopt a policy in order to regulate them in a transparent and *ex ante* fashion is a welcome sanction of a practice that most best-practice bank boards have been following for some time.

We also welcome the reduced emphasis on board alignment to shareholder interests, which has been very much a theme in the broader corporate governance debate. Paragraph 13 of the introduction notes that the board and senior management “*protect the interests*

of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders", while Paragraph 26 requires the board to *"set performance standards for senior management consistent with the long term objectives, strategy and financial soundness of the bank"*. None of the above statements seem to give primacy to pursuing shareholder value. Given banks' public interest significance, the effective underwriting of their liabilities by the government (which we do not expect to see ending any time soon) and their unique funding and capital structure, we agree with a governance philosophy that does not see as the board's overriding role that of shareholder fiduciaries. Directors should first and foremost consider themselves the guardians of the long-term solvency of an institution.

In the rest of this note we focus on what we consider to be the four main weaknesses of the Principles: (1) the very high expectations placed on parent or subsidiary boards; (2) the unbalanced focus on senior management accountability to the detriment of senior management responsibility and leadership; (3) the understatement of the role of senior management *as a collective whole* in managing risk, including its role in developing the framework for setting the risk appetite; and (4) the very ambitious role for supervisors in bank governance.

1. Boards should not be required to do more than they can realistically deliver

There are significant risks in piling up responsibilities on boards. First, too many "reviews" and "approvals" push boards into rubber stamping as NEDs rarely have the information required to make decisions, while their independent and part-time role does not allow sufficient time to acquire and digest such information. Rubber stamping in turn results in lower levels of responsibility and therefore accountability for management ("you approved this!") and a weaker control environment ("they do not even look at this stuff!"). In addition, an expansive focus on control distracts NEDs from their other key responsibility: providing strategic direction. Therefore, asking the board to *"establish a governance structure which contributes to the effective oversight of subsidiaries"*, *"ensure that enough resources are available for each subsidiary (...)"* or *"have appropriately means to monitor that each subsidiary complies with all applicable governance requirements"* (Paragraph 61) are onerous tasks that are better assigned to management. The same is true for establishing a "know-your-structure" procedure (Paragraph 119). What the board really needs to do in the area of group governance is focus on setting and approving a group governance policy providing the framework in which management determines optimal

group structure and allocates resources. The board should also receive adequate feedback on the implementation of the policy.

The draft Principles seem to suggest that all board committees should be composed of non-executive directors (Paragraphs 50-52). As regards board risk committees, this should not be recommended and, as a matter of fact, a number of unitary boards which performed well during the crisis had appointed executive directors to their risk committees. The monitoring of a bank's risk should remain the joint responsibility of executives and non-executive directors. Also, the contribution of the risk committee should be less about the control of management (which is more the focus of the audit committee) and more about the provision of a strategic, forward looking view to the board on the bank's operating environment from a risk perspective.

When it comes to subsidiary boards, the Principles are somehow ambivalent as to the nature of the proposed governance blueprint. While clearly recognising the need for a corporate governance policy for the group they also state in Paragraph 59 that *"the board of a regulated banking subsidiary (...) should adhere to the same corporate governance principles as those expected of its parent company"*. Despite the proviso introduced by *"absent other legal requirements or reasons of proportionality"*, this principle should be clarified as it might be misinterpreted to mean that a subsidiary board should follow the same governance rules as the parent board, which would be a misleading recommendation. For example, the board of a wholly-owned subsidiary does not need to be "independent" of its shareholder (at least when there is a 100% ownership) neither does it need to establish fully independent oversight over the subsidiary's internal control. Such "independence" might indeed negate the very parenting value of large banking groups to their local subsidiaries. What subsidiary boards should adhere to are the corporate values of the group and the group governance policy. While the role of subsidiary boards could differ from one group to another, depending on individual group structures, the key responsibilities of a subsidiary board should be to ensure that the governance and management of the subsidiary is fit for purpose, that the subsidiary meets all local compliance requirements and that the interests and concerns of local stakeholders are sufficiently addressed.

2. The leadership role of senior management should not be underplayed

Principle 5 states that the key role of senior management is to “(...) ensure that the bank’s activities are consistent with the business strategy, risk tolerance / appetite and policies approved by the board”. While this is, indisputably, a key aspect of the role of senior management, Principle 5 and the following paragraphs paint a picture of senior management as implementation agents of the board rather than business leaders. This is neither the reality nor should it become an aspiration. The leadership of the bank resides with its top executives. That is why, for example in the UK, the UK Corporate Governance Code recommends the appointment of senior executives to boards. Management accountability to the board should not result in management having less of a leadership role. Rather, senior management is and should remain responsible not only for meeting every significant business challenge and for leading the people that make the business a success (and banking is a people businesses...), but also for developing the strategy, as well as the framework and the tools for setting risk appetite for the board’s discussion and approval. This goes well beyond the “implementing” responsibility suggested by Paragraph 66.

Another symptom of the tendency to move things “up” to the board is the weakening of the accountability of the chief risk officer (CRO) to senior management suggested in Paragraph 72. The CRO is and should remain a key member of senior management. His/her function is not an *ex post* control function similar to audit. He/she is a direct contributor to the business. While direct reporting and access to the board is needed and the board should have a say in his/her hiring and firing, there is no reason that this say should be different in nature than the board’s role in firing and hiring other members of the executive committee of which the CRO should be a member. A special approach to the accountability of the CRO might actually remove him/her from the inner top management circle and thus become counterproductive from a governance perspective.

3. Managing risk is the collective role of senior management not only of the risk function

The draft Principles seem to understate the collective role of senior management in managing risk and controlling the risk profile of the bank. Paragraph 95 notes that “some firms found it useful to create risk management committees (...) to discuss issues related to firm-wide risks”. In reality, best practice firms have long established a sophisticated and flexible structure based on various risk management committees that have frequent and detailed views of key risk “buckets”. These committees are often overseen by a firm-wide

management committee—usually the executive committee under a different name—which consolidates management’s view of risk and is the forum for policy discussions of the issues that eventually go up to the risk committee of the board. This structure should continue to be recommended as an important mechanism for ensuring firm-wide risk management coherence and avoiding organisational silos. While boards should beef up their capacity to oversee risk management and provide explicit appetite guidance, it is unrealistic to expect them to take upon themselves the consolidation of the risk profile of large, global, complex businesses. It is in fact a senior management committee, usually the firm-wide risk committee, which prepares the board’s discussion on risk appetite and the risk capacity of the firm, contrary of what Paragraphs 63-64 seem to suggest.

In the same vein, the management of risk exposures should not be the job of the risk management function, as Paragraph 84 seems to suggest. But neither should the function *“simply report risk positions and monitor these positions”*. The bank should have an agreed policy for managing exposures that exceed limits. This policy should involve the risk function and allow for “escalation” when the risk function is not in agreement with the relevant business. The management of risk within agreed limits should clearly remain the responsibility of businesses, while a robust reporting system should ensure that the risk function is in a position to monitor the risk profile of the firm on a real time basis.

The draft Principles should also stress more than is currently done in Paragraph 88 the very important role of the finance and treasury functions in managing funding, liquidity, capital and certain other structural risks such as forex and interest rate risks. In this regard, a very close coordination between the finance/treasury and risk management functions is essential for a coherent and holistic management of risk. A number of global banks feel that this is best achieved by integrating the risk management function under the chief financial officer—a practice that was interestingly followed by some of the most successful banks during the crisis.

4. Expectations regarding the capacity of supervisors to oversee bank governance and address on-going governance issues should take into account their capacities and limitations

We fully agree that “(...) a key role of supervisors (...) is to ensure that banks practice good corporate governance” (Paragraph 129). However, we are sceptical about the guidance provided to supervisors in section IV of the Principles to help them fulfil this responsibility.

While the requirement that existing and prospective board members meet fit-and-proper criteria is sound (see Paragraph 134), the value of a regulatory vetting of individual directors by supervisors is rather limited. Indeed, leading top-tier global banks would usually appoint sufficiently qualified people to their boards, so fit and proper controls by regulators would add value mostly to second and third tier institutions in particular jurisdictions. Moreover, putting too much weight on the regulator’s fit-and-proper processes might create a box- ticking approach to promoting board competence. What is definitely needed is a clear directive to banks to have effective nomination policies and processes, and determine clear candidate profile that incorporate fit-and-proper and other criteria (which should not be limited to the “independence” requirements of governance codes). The nomination policy and process of a bank should be verifiable by regulators.

In Paragraphs 131-133 the draft Principles recommend a “*comprehensive evaluation of a bank’s overall governance policies*”. We doubt that even the most sophisticated regulators have either the staff-level expertise or the resources to engage in such comprehensive governance assessments. Moreover, given the trend for more hands on monitoring of management—a welcome post-crisis imperative that follows the example of successful countries like Canada—it is doubtful whether significant additional resources could be found for this purpose.

Instead of requiring a governance assessment by supervisors, we propose two measures, to be implemented jointly, that share the same objectives but are more likely to yield results in practice:

- (1) A requirement for banks to undergo a regular (e.g. every 3 years) external assessment of their governance by qualified external experts. This assessment should be reviewed by the board, which would agree on a relevant action plan for changes as required. The synthesis and action plan would be communicated to the regulator, who would be regularly apprised of progress in implementing changes agreed in the action plan. The

recently published Walker review in the UK proposed a similar measure which has been endorsed and included in the latest version of the UK Corporate Governance Code for all FTSE350 companies. Paragraph 42 of the draft Principles should be reworded to this effect.

- (2) Individual annual meetings between the leadership of the supervisor and the boards of the largest, systemically important banks in a particular jurisdiction (or part of the board represented by its leadership, i.e. the board chairman, the chief executive and committee chairs). This meeting would focus on key aspects of strategy, risk appetite and governance, as well as the findings and action plan of the assessment under (1). Having a meeting at leadership level is the only way to ensure that supervisors have the clout to ask tough questions and receive valid commitments at board level, in parallel to the commitments that senior supervisory staffs receive from senior management in the course of the supervisory cycle. The meeting might also prove to be a very important source of information and understanding of both micro- and macro- prudential issues for the supervisor. This process would also put pressure on the board to develop an explicit point of view on the key strategic, risk and governance issues of the banks they lead, which can be communicated effectively and in a way that instils confidence in the institution, and would go beyond the generalities and legalistic formulas often used in regulatory disclosures.

I hope that you find these comments helpful and would be happy to discuss any of these matters further.

Yours sincerely,

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