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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Subject: Corporate governance principles for banks – Response to the consultative document by Nestor Advisors

Nestor Advisors Ltd is a London-based consultancy focusing exclusively on corporate governance. Our most important client base is the financial sector. We have worked with the leaders of several top 20 Eurozone banks to assist them in improving corporate governance and decision making. We have helped transform the governance of several large banks in the Middle East, Africa and Latin America. We regularly publish comparative studies on the governance of the largest 25 European banks and are often asked to contribute to policy initiatives on banking sector governance, having advised, among others, the EU Commission, the EBRD, the IFC/World Bank and Sir David Walker in his review of UK bank governance.

Nestor Advisors is grateful for the opportunity to comment on the draft Corporate Governance Principles for Banks (the “Principles”). We hope that our comments can contribute to a robust set of guidelines that will assist banking organisations in improving their performance and resilience through better corporate governance. We are also conscious of the important role the Principles play in the development of local regulation. It is not uncommon to see Principles-based guidance transposed into mandatory rules in many (especially emerging market) jurisdictions with little or no change. Careful choice of scope and precise framing are therefore a critical element of their success.

A. Improvements in the Principles

Overall, we find that the amendments to the Principles effectively incorporate the post-crisis “lessons learned” on bank governance and in reflect current trends among leading banking regulators. We especially appreciate the emphasis of the amendments on the increasing role of the supervisor, the importance of culture, the expanding role of the board in risk governance, and the additional focus on director suitability and management incentives.

We welcome the formalisation of the role of the supervisor in the “evaluat[ion] of the processes and criteria used by banks in the selection of board members and senior managers” (§ 162, p 34), which recognises as best practice an approach that in many jurisdictions is already a mandatory requirement. The Principles go even further in explicitly requiring that the

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supervisor should have the “ability to compel changes in the bank’s policies and practices, the composition of the board of directors or senior management” (§ 167, p 35).

We applaud the new emphasis on culture and the effort made to identify key tools for cultural change in order to improve behaviours and conduct. The Principles are quite ambitious in this respect and ask supervisors to get out of their “comfort zone” to ensure that there is an on-going focus on this important but quite complex area.

The increased focus on risk governance and especially on the stature, competence and authority of the risk management function and its head, the Chief Risk Officer (CRO), is also a reflection of emerging best practice. In many jurisdictions, the regulatory and supervisory framework directly addresses these issues.

In contrast to the current version (published in 2010), which focuses on independence, the amended Principles are more explicit on the need for non-executive knowledge, skills and experience on boards. This is a welcome rebalancing. It addresses (albeit implicitly and not always consistently) what proved to be a key bank governance weakness in the run-up to the 2008-9 crisis: too much “independence” and too little expertise on the boards of highly complex businesses.

Finally, explicit guidance in the design of effective compensation systems including malus/forfeiture provisions and claw-back provisions (§ 151, p 30), should be welcomed as the standard for large banks in which a significant percentage of compensation is variable.

B. Key issues in the draft Principles

In the second part of this note, we focus on what we consider to be the areas for improvement of the draft. Our comments address six of the principles: Principles 1-3 on board responsibilities, qualification and structure; Principle 9 on compliance; Principle 10 on internal audit; and Principle 13 on the role of the supervisor.

Principle 1: Board’s overall responsibilities

a. The concept of culture

Draft Principle 1 states that “the board has overall responsibility for “... approving and overseeing...corporate culture”. Accordingly, the board is required to “establish the bank’s corporate culture and values” (§ 23, p 7). These statements suggest that there is a misunderstanding of what culture is. While boards should establish and monitor business objectives, strategy and policies, it is difficult to understand what either the “approval” or the “establishment” of culture would entail.

At Nestor Advisors, we view culture as “process over time”, i.e. the ways in which the members of an organisation have learned to accomplish (and expect others to accomplish) all work-related tasks, and their conduct towards all affected parties in doing so. While culture is “real” and important, it can only be changed by targeting specific policies, incentives and behaviours that, over time, affect “the way we do things”. Targeting must be sustained and consistent, but there is no process for “approving” a culture ex ante. A board cannot

“establish” a culture, but it can take measures to facilitate the emergence of certain behaviours over time.

The first task of the board is to regularly assess and understand the corporate and risk culture of the institution and to identify weaknesses in reference to its own values, to the bank’s strategic aspirations and to the expectations of its stakeholders, including the supervisors. Regular assessment should lead to the development of cultural change objectives that can be achieved through the setting of specific policies, incentives or conduct targets. Implementing these targets will eventually change “process over time”.

In view of the above we suggest that the text of Principle 1 should read as follows: “The board has overall responsibility for the bank, including approving the bank’s strategic objectives and governance framework; and ensuring the adequacy of the bank’s corporate culture...”. Paragraph 23 point 2 should read: “articulate the bank’s values, monitor the bank’s corporate culture and take corrective measures to address weaknesses as required.”

b. Board and CEO authority and senior management accountability

It is important that the board’s power to hold management accountable does not undermine the accountability of the senior management team to the CEO. We believe that the current language in § 44 might be misinterpreted as a suggestion that the board should directly hold senior management accountable, thus bypassing (or competing with) the CEO. In order to avoid such a misrepresentation, we suggest inserting the sentence “without undermining the authority of the CEO” in the beginning of the second sentence of § 44.

c. Risk governance

The three lines of defence are currently defined too narrowly in § 36. The BCBS could adopt a broader view, encompassing a broader range of actors.

The role of the finance and treasury functions (not usually referred to as “businesses”) in directly managing funding, liquidity, capital and certain other structural risks such as Forex and interest rate risks, should be included in defining the perimeter of the first line of defence. In this regard, very close coordination between the finance/treasury and risk management functions is essential for a coherent and holistic management of capital, liquidity and funding risk and this should be explicitly recognised by the Principles. Moreover, other functions such as Legal and IT are front-line risk managers in their respective areas and could be identified as such.

The second line of defence currently includes the risk management and compliance functions. It should also include other oversight functions such as financial control and human resources as suggested by COSO’s *Enterprise Risk Management* (2012). These functions also set directions, define policies and provide assurance in the management of operational risk to the “first line defenders”.

Currently, the third line of defence consists only of the internal audit function. External auditors and other independent assurance providers should also be included here.

Principle 2: Board qualifications and composition

a. The role of executive directors

The Principles state that “board candidates should not have any conflicts of interest that may impede their ability to perform their duties objectively and subject them to undue influence from other persons (such as management or other shareholders)” (§ 50, p 11). As it is currently drafted, this provision seems to exclude (or at least, discourage), the appointment of either executive directors or shareholder representatives. We consider this approach to be ill-advised.

Bank boards in unitary board systems should not be transformed into supervisory boards. Executive presence is an important source of information to non-executives and it reflects a culture of collegiality in the executive leadership. The presence of other executives limits the power of the CEO to single-handedly influence the view of the board on strategic and control issues; and it makes the top executive team directly accountable to shareholders.

The presence of significant shareholder representatives in both unitary and two-tier board systems should be welcomed (or at least, not discouraged). It is an arrangement that enhances monitoring and control over management. In both cases, there will of course be conflicts that require that independent directors (non-management, non-shareholder representatives) to be in charge of some key areas such as compensation, financial control and related-party transactions. But these conflicts are manageable: they are indeed the reason that independent board committees were established in the first place. Avoidance of conflicts should not lead to “throwing out the baby with the bath water”.

In view of the above, we believe that the Principles should make clear that executive or shareholder representatives are not undesirable, as long as (a) there is a significant component of independent directors on the board and (b) as regards shareholder representatives, they fulfil the suitability requirements and compositional needs of the board.

Principle 3: Board’s own structure and practices

a. Balancing the authority of the executive chairman

The Principles state that a larger number of non-executives on the board would provide more challenge to executive board members and an executive chairman (§ 61, p 13). Whilst we fully support the appointment of a lead board member or senior independent board member, large numbers of non-executive directors on the board might result in a size that affects the board’s effectiveness.

“More are not merrier” when it comes to a bank board’s capacity to challenge. It is the relative gravity, knowledge, skills and experience of the independent directors rather than their number that will balance a strong executive chairman. Also, the presence of executives other than the CEO on the board might actually reinforce the latter’s “challenge capacity” by attenuating the non-executives’ dependence on a single, too-powerful individual. Our own research on a sample of international banks showed that, during the 2008-9 crisis, banks with only one executive on the board (usually the CEO) largely underperformed compared to both those with no executives on the board (including those with two- tier boards) and those with

more than one executive on their unitary boards. The latter two categories performed approximately at the same level.

b. Committee chairmanship

A related point is the requirement that the (non-executive) “chair of the board should ... not serve as chair of any board committee” (§ 60, p13). As a general rule, this provision might actually weaken the authority of the chairman vis-à-vis that of the CEO.

Not allowing the chairman to chair the nomination committee seems particularly counterproductive. We actually believe that the opposite is good practice. The primary role of the non-executive chairman is to lead the board. It is consistent to expect the leader of the board to also lead the effort to ensure an adequate profile for the team he/she will be leading. This is achieved through succession planning, an effective board evaluation process as well as the quality and “fit for purpose” of the organisation’s governance. These are all core functions of the nomination committee. It is therefore “natural” that the board chairman should lead the nomination committee. Moreover, the board chairman is usually closer to the shareholders than are most other NEDs. Therefore, his/her chairmanship of the nomination committee will, in principle, encourage a more active shareholder input in board succession planning. We note that half of the largest 20 European banks have their board nomination committees chaired by the chairman of the board.

The argument that the Chair should be a member but not the chair of the committee seems somehow incongruous. Committees require strong, informed leadership that counterweights the informational advantage of the CEO. The excessive fragmentation of NED power in the elusive search for evermore “checks and balances” might actually achieve the opposite result. It is this approach that, in the run up to the crisis, led to bank boards in which directors were too disinterested to effectively challenge powerful CEOs.

There are, of course, conflicts that may arise from the appointment of the board chairman as chairman of the nomination committee (for example, his/her own performance evaluation) but they are all manageable, especially in the presence of a senior (or “lead”) independent director.

While the requirement to have the audit and risk committees led by someone other than the chairman is sound, the requirement that they are chaired by different people might also be misguided. In some (but not all) cases, having one non-executive lead the two committees might actually yield positive results: it might allow the emergence of one more powerful, informed NED (other than the chairman) with the capacity to challenge management in this key area and actively contribute to strategy development. It might also facilitate close and effective coordination of the work of the two committees, especially in areas such as provisioning and operational risk.

c. Required committees

We were surprised to see in § 76 (p 16) that the nomination/human resources/governance committee and the ethics/compliance committee were placed at the same level. The former is now a regulatory requirement in many leading jurisdictions and a widely accepted component of bank boards. The ethics/compliance committee, on the other hand, is currently not very common. Only four out of the twenty five largest European banks have a

conduct/values/integrity committee while only one has a standalone compliance committee. Many boards choose to leave the oversight of compliance, along with other operational risks, to the audit and/or risk committee of the board. This should be sufficient in most, but not all, cases. For example, it might not suffice when the bank has suffered compliance failures and is implementing significant changes in this respect. Our experience however suggests that a general requirement for an additional board committee will have little or no effect in minimising (future) compliance risks, with the potential downside of a further increase in the size of the board and a further fragmentation of its work.

In view of the above, we believe that the Principles should give a stronger endorsement of nomination committees as an essential part of a bank board's institutional machinery. They should mention ethics/compliance committees as an option for bank boards, especially the ones whose reputation and P&L has been damaged because of compliance failures.

Principle 9: Compliance

a. Boards and compliance

The draft introduces a new Principle 9 on compliance. In our view, singling out compliance as a “paramount” board responsibility requiring its own Principle, over and above the list of responsibilities included in Principle 1, might be sending the wrong signal.

What many bank board members tell us is that they now spend between 25-40% of their time on compliance matters. This is not healthy. Boards are there to guide and oversee, not to police. Spending the board's limited time on compliance matters will result in a weaker focus on key strategic issues and emerging risks. It might “bureaucratize” the work of the board and discourage challenge since discussions on compliance are based on the approval of formal reports by management, a process tinged with liability. Ultimately, it will make boards less effective and less valuable to the companies they lead.

All this does not mean that the board should have no role in compliance. The second paragraph of Principle 9 on the board's approval of the approach, policies and establishment of the compliance function should indeed be among the responsibilities of the board laid out in Principle 1, while the chief compliance officer should regularly present the annual plan and key findings to the board's audit (or risk) committee.

b. Management and compliance

Compliance is first and foremost the responsibility of management, something that the Principles seem to recognise in § 133. The chief compliance officer is part of senior management, but with direct access to the board. This is the way § 136, on the independence of the compliance function, should be read—and perhaps it is worth clarifying this perspective in the text.

Principle 10: Internal audit

The scope and mandate of the internal audit function in Principle 10 could be further enhanced. Best practice suggests that the audit committee should review the effectiveness of the internal audit function, and that it is important for the head of internal audit to have a strong relationship with the CEO.

Principle 13: The role of supervisors

Principle 13 calls for “comprehensive evaluations” of corporate and risk governance and culture. Paragraphs 160-163 set the bar very high in terms of the scope and depth of these on- and off-site supervisory reviews.

While we agree with the requirement that banks should regularly monitor their governance and culture in the way described in these paragraphs, we remain sceptical as to whether supervisors have or can build the capacity to make in-depth assessments in these areas on their own. In our experience, even the most sophisticated supervisors have limited expertise and experience in governance, especially at board level. Assessments cannot easily be reduced to a box ticking template. While such a template would probably make assessment by non-experts easier, it would, in the long run, be counterproductive because it would limit supervisory and most probably board perspectives to procedural aspects and allow emerging governance and cultural risks (for example. those linked to behaviours) to go largely undetected.

In our view, the Principles should emphasize the need for supervisors to gain assurance that banks have adopted a regular, consistent and robust approach in conducting these assessments themselves. When such assurance is not forthcoming, supervisors should have the right to appoint their own third-party experts (from an approved list) to conduct assessments on their behalf. This is already the model of leading supervisors such as the UK PRA/FCA.

We hope that you find our comments helpful and remain at your disposal for clarifications or further discussion of these points. Should you have any queries, please contact Federico Bottarelli Bernasconi (fbbernasconi@nestoradvisors.com).

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