Response to Basel Committee on Banking Supervision
Consultation – October 2014

Corporate governance principles for banks

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

7th January 2015

Dear members of the Secretariat,

I would like to start by acknowledging the important role of the Basel Committee as the primary global standard-setter for the prudential regulation of banks and providing a forum for cooperation on banking supervisory matters.

I am in full agreement that effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. However ongoing events continue to highlight various weaknesses and deficiencies in existing banking governance and oversight frameworks, and highlight the requirement for an improved approach in order to better safeguard the interests of the multiple stakeholders. The Basel Committee is therefore in a unique position to help address these weaknesses and help improve ongoing governance and oversight within the banking sector.

I would like to state for the record that in my opinion this consultation document is a welcome compliment to existing guidance. My feedback is therefore not intended to be a criticism in any way, but rather a constructive attempt to contribute to further improvement in this space. Please find attached my comments in relation to required amendments which are in the form of two appendices.

Appendix I: Specific Observations and Recommendations

Appendix II: An example of a Board Oversight framework

I would like to thank the Basel Committee for providing this opportunity to comment on the consultation draft. Should you require any additional information or wish to discuss any of the issues raised in more detail please do not hesitate to contact me.

Yours sincerely

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APPENDIX I

SPECIFIC OBSERVATIONS

A. Delivering Long Term Sustainable Stakeholder Value[1]

In the minds of many stakeholders an organisation has a corporate responsibility to defend their stakeholder interests. This responsibility includes safeguarding, protecting, and valuing the interests of all of its stakeholders, with a view to ensuring the long term sustainability of stakeholder value. This responsibility begins with the board.

The financial crisis of 2008 and the subsequent economic recession highlighted serious weaknesses in corporate business models and exposed a mindset of excessive risk taking in search of short-term rewards at the expense of achieving longer-term sustainability. Such recklessness has severely tarnished the reputation of the corporate world in the eyes of many of its stakeholders. Consequently there has been increased stakeholder focus on, and scrutiny of, boardroom affairs, with many stakeholders now demanding higher standards of board oversight in order to provide them with better protection and greater assurance going forward.

An old sporting aphorism states that "offence wins games, defence wins championships". In business the ability to deliver sustainable value to stakeholders requires a subtle blending of both value creation (offence) and value preservation (defence) efforts. This requires an understanding of these two antagonistic yet complimentary principles, which are inherently intertwined and mutually interdependent within a dynamic environment. It requires an appreciation that these two principles represent two sides of the same coin, and therefore cannot and should not be addressed in isolation of one another. Now more than ever, 21st century business requires a balanced integration of both value creation and value preservation at all levels of the business.

Recommendation: Board Governance should include ensuring the existence of a healthy corporate strategy which reflects a balanced focus on both value creation and value preservation. Unfortunately the financial crisis clearly highlighted the existence of an unhealthy imbalance in this regard. It is now apparent that in the build up to the financial crisis too many boards were preoccupied with focusing on short term value creation at the expense of long term value preservation.

Note: *The BIS consultation document does refer to the role that the corporate governance framework has to play in addressing strategy, however it does not currently refer to the important strategic objectives of long term sustainability, value creation, or value preservation.*

[1] This submission is largely based on my article entitled "Striking a Balance: Offence v Defence" which was recently published in The Ethical Boardroom Magazine, Winter Edition, 2014 (also available online at their website: http://ethicalboardroom.com/risk/striking-balance-offence-v-defence/)

B. Boardroom Focus on the Value Preservation Imperative[2]

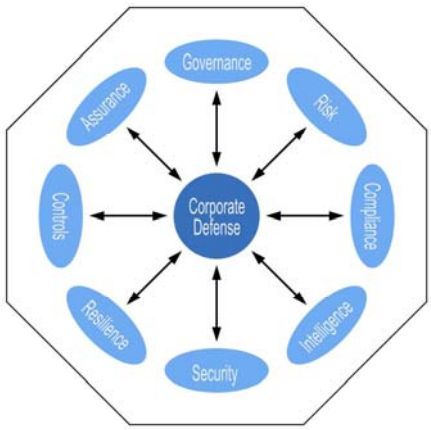
Value preservation is widely associated with the notions of guardianship and protection. In its broadest sense it encompasses an organisation's collective efforts at self-defence. The concept of the value preservation imperative refers to the necessity to defend the organisation itself and the interests of its stakeholders. This requires safeguarding against a multitude of potential hazards (risks, threats, and vulnerabilities), the occurrence of which could be detrimental to the achievement of the organisation's objectives, and consequently to its long term sustainability. This includes the board being able to successfully demonstrate that it has taken all reasonable steps to ensure that there is a robust corporate defence programme in place to help achieve its stakeholder obligations.

Everyday in the media we see scandals whereby organisations have found themselves in difficulties all of their own making. These are often as a result of events and/or series of events which in retrospect the organisation could have and should have better anticipated, prevented, detected or reacted to. Typically these scandals have exposed deficiencies and weaknesses in their corporate defence programmes which have led to unnecessary large scale losses, significant reputation damage, and negatively impacted on stakeholder value. Clearly from a stakeholder perspective corporate defence represents a very important challenge which needs to be adequately addressed by the board. In fact some stakeholders would argue that the board's true valuation of their stakeholders is most clearly reflected in the organisation's corporate defence efforts.

The board in particular needs to be aware of, understand, and appreciate each of the critical components of a corporate defence programme (Figure 1) and the purposes they serve.

- **Governance:** How the organisation is directed and managed, all the way from the boardroom to the shop floor.
- **Risk:** How the organisation identifies, measures, and manages the risks it is exposed to.
- **Compliance:** How the organisation ensures that its activities are in conformance with all relevant mandatory and voluntary requirements.
- **Intelligence:** How the organisation ensures that it gets the right information, in the right format, to the right person, in the right place, at the right time.

Figure 1: Critical Components



[2] Please also see my 2012 submission to the HBR/McKinsey M-Prize for Management Innovation: Long-Term Capitalism Challenge, entitled "Achieving a Healthy Balance Between Offense and Defense in 21st Century Capitalism". http://www.managementexchange.com/hack/achieving-healthy-balance-between-offense-and-defense-21st-century-capitalism

▪ **Security:** How the organisation ensures that it protects its critical assets from threats and danger, its people, information, technology and facilities.
▪ **Resilience:** How the organisation ensures that it has the capacity to withstand, rebound or recover from the direct and indirect consequences of a shock, disturbance or disruption.
▪ **Controls:** How the organisation ensures that it has taken appropriate actions in order to address risk and to help ensure that the organisation's objectives will be achieved.
▪ **Assurance:** The system in place to provide a degree of confidence or level of comfort to the stakeholders that everything is operating in a satisfactory manner.

Successful corporate defence involves the alignment and co-ordination of these inter-connected and inter-dependent defense related activities which need to be managed in an integrated manner. A corporate defence programme therefore involves the collective management of all these components in order to help maximise their potential added value. Their collective management is required as recent developments in each of these disciplines has meant that the boundaries between these activities have become somewhat blurred, and therefore it is now increasingly difficult to determine where one component ends and another begins, as each includes elements of the others.

Recommendation: Board Governance should involve ensuring that the organisation can demonstrate that it has a robust corporate defence programme in place. Effective corporate defence requires an appreciation by the Board of the continuous interaction, interconnections, and critical interdependencies which exist between these disciplines and the potential cascade of consequences which can result. It requires an understanding that the management of these complimentary components continuously impact on one another in this increasingly complex corporate ecosystem. In fact the symbiotic nature of their relationships means that each contributes to, and receives from, each of the other disciplines.

Note: *The BIS consultation document currently addresses the governance and risk aspects in some detail. The document also refers to the compliance, controls, and assurance aspects, however it does not currently address the other critical aspects of intelligence, resilience, and security (including cyber-security).*

C. The Requirement for an Extended Five Lines of Defence Oversight Model[3]

In order to gain a measure of comfort that critical activities are being appropriately addressed, stakeholders commonly rely on various lines of defence to be in place and to operate as oversight layers within their organisations. These internal lines of defence are responsible for providing stakeholders with a degree of confidence that the organisation is operating effectively and in an appropriate manner.

The lines of defence oversight approach is intended to operate on the principle of providing transparency in the assignment of oversight responsibilities, and in holding individuals (or groups) to account for these responsibilities. The logic of such an approach is that each line of defence has specific oversight responsibilities for monitoring and reporting on the performance of the activities of other lines of defence. Each line of defence therefore has "*skin in the game*" and has the capability to provide separate and additional levels of comfort which can be relied upon in the event that a subordinate line of defense fails to operate effectively.

A number of different hierarchical lines of defence therefore exist to help ensure that appropriate corporate oversight is in place at all levels within the organisation itself and beyond. Each of these lines of defence has differing oversight roles, duties and responsibilities and if operating effectively all are expected to make a valuable contribution to the overall corporate oversight framework. Such a "lines of defence" approach enables vertical (top-down, bottom-up) and horizontal (cross-functional) oversight of the organization's activities, providing the organization with both defence-in-depth and defence-in-breadth in the process.

The Three Lines of Defence Model

The three lines of defence model is a commonly applied concept that has been in operation across different industries and geographic regions for some time. This model represents a common approach to providing oversight. It recognizes operational line management[4], tactical oversight functions[5], and independent internal assurance[6] as individual lines of defence. The three lines of defence has historically often been the preferred model of regulators when they review an organisation's oversight structures. Unfortunately while this model recognises an oversight role for executive management and the board of directors, it does not recognise these specific roles as important additional strategic lines of defence.

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[3] Please also see my 2011 paper entitled "Corporate Oversight and Stakeholder Lines of Defense", published in the Conference Board, Executive Action Report No. 365 : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1938360

[4] Sometimes referred to as "management" or "the business".

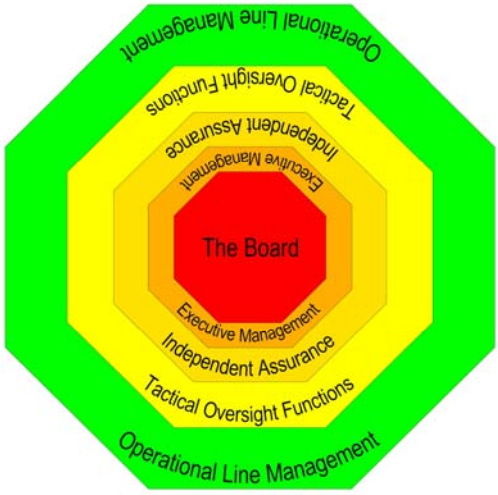
[5] Sometimes referred to as "business enabling functions", "risk functions", "compliance functions" or "control functions".

[6] Sometimes referred to as "internal audit".

The Five Lines of Defence Oversight Model

The global financial crisis clearly highlighted the inherent weakness in placing sole reliance on the oversight roles of first three lines of defence. Given that failures in board and executive management oversight of risk was commonly identified as a contributing factor to the crisis, an increasing number of regulators and other commentators are now focusing attention on the specific strategic oversight roles of these two additional lines of defence. In fact many observers are now beginning to regard these as the most important lines of defence from a strategic perspective. For this reason it would appear logical and prudent for organisation's to focus on implementing the more comprehensive extended five lines of defence model which specifically includes the additional strategic oversight roles of executive management and the board.

Figure 2: Five Lines of Defence



1. **Operational Line Management** has responsibility for overseeing the daily operations of staff, services, practices, mechanisms, processes, and systems.
2. **Tactical Oversight Functions** monitor, facilitate, and coordinate the consistent, competent, adequate, and effective operation of defence activities established by operational line management. Examples include the compliance, risk management, and internal control functions.
3. **Independent Internal Assurance** provides the board with a level of independent assurance in relation to the effectiveness of the activities of the other lines of defence. Examples include the audit committee, risk committee and the internal audit function.
4. **Executive Management** provides assurance to the board that the objectives of the organisation are being achieved by providing adequate oversight of those they manage and by ensuring that the organisation's activities are consistent with business strategy and policies approved by the board.
5. **The Board** is responsible for overseeing the activities of the organisation and is accountable to the shareholders for the organisation's strategy and performance. This includes overseeing the activities of its standing committees and executive management.

It is essential that each line of defence recognises that it has specific responsibilities in relation to each of the critical corporate defence components. To operate effectively each line of defence must play its part both individually and collectively (the chain is only as strong as its weakest link) thereby fulfilling their oversight duties within a holistic framework. Corporate defence is ultimately a team sport in which each line of defence is accountable for helping to safeguard the diverse interests of the multiple stakeholders.

Recommendation: Board Oversight should involve ensuring that the extended five lines of defence oversight model is in place and operating in a satisfactory manner. The Board as the last line of defence must appreciate that these oversight responsibilities begin at the boardroom but run right through the organisation all the way to the front line (the 1st line of defence).

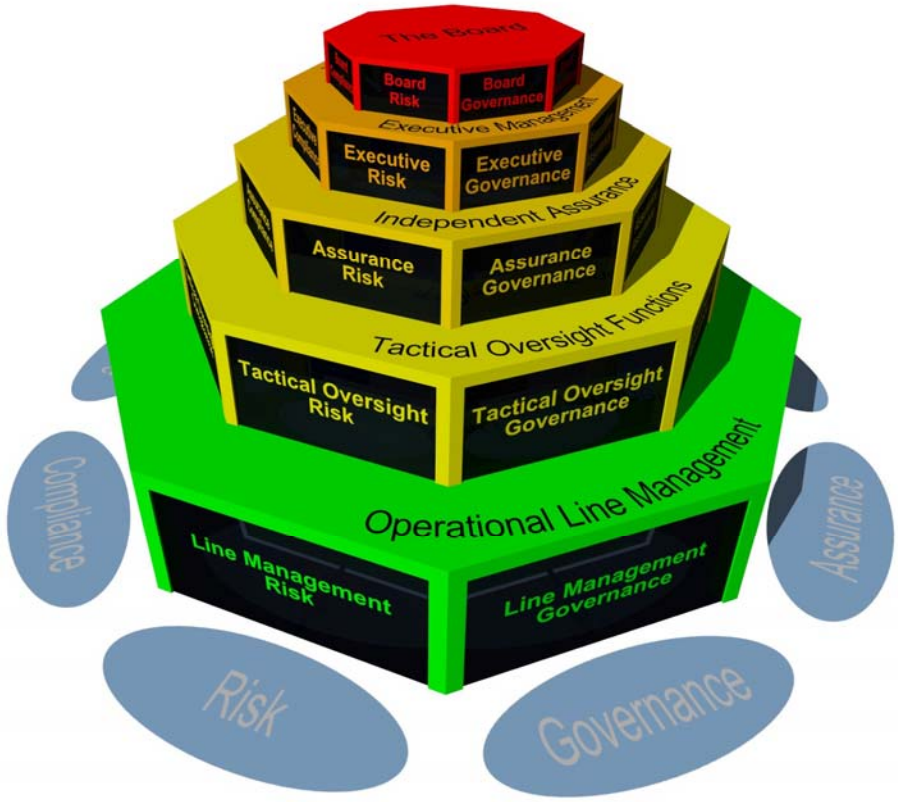
Note: *The BIS consultation document currently refers to the three lines of defence model as a mechanism for identifying the responsibilities of different parts of the organisation for addressing and managing risk. Unfortunately this approach excludes the important roles of both executive management and the board as necessary additional strategic lines of defence. The lack of appropriate strategic oversight by the board and executive management is an issue which has regularly been highlighted as a contributing factor to the global financial crisis and indeed in subsequent financial scandals.*

APPENDIX II

Corporate Defence Management (CDM) Framework

A truly holistic perspective requires a conceptual understanding and practical appreciation of how to successfully integrate the critical defence components at each line of defence. The CDM framework (see Figure 3) represents a multi-dimensional model which can help an organisation to visualise this integration while also helping to understand their continuous interactions, interconnections and critical interdependencies. The implementation of the CDM framework can help to better manage the critical defence components by unifying, aligning and integrating them at strategic, tactical and operational levels. Such a framework enables the board to provide appropriate oversight to address the organisational challenge of transparency over corporate defence responsibilities and accountabilities.

Figure 3: Multi-dimensional CDM Framework[7]



[7] Please refer to short video which provides a visual image and overview of the workings of this multi-dimensional framework: http://www.youtube.com/watch?v=vLoA8U0GZHI