Bank boards – a review of post-crisis regulatory approaches[1]

Executive summary

The corporate governance of banks differs from that of non-financial firms, due to the vital role they play in an economy. Banks intermediate funds from depositors to businesses and consumers, spurring economic growth. Their safety and soundness is therefore key to supporting the needs of the real economy and in fostering financial stability. Banks differ from non-financial firms in other ways too, such as their high leverage and heavy reliance on depositors and debt holders to fund their activities. How banks conduct their activities thus affects a broad range of society.

The Great Financial Crisis (GFC) exposed shortcomings in banks' corporate governance practices. Investigations by national authorities and international organisations found that bank boards were constrained by "groupthink", deferred excessively to senior management, allocated insufficient time to oversee the firm and lacked experience and knowledge. Other weaknesses included ineffective board structures and poorly designed compensation frameworks that led to excessive risk-taking.

Following the GFC, standard-setting bodies have tightened bank governance standards. In 2015, the Basel Committee on Banking Supervision and the OECD issued updated guidelines on corporate governance principles. In 2017, the Financial Stability Board conducted a corporate governance thematic review, focusing on how their members have applied the OECD Principles to listed financial institutions.

This study takes stock of specific aspects of the post-crisis regulatory approaches used in 19 jurisdictions to strengthen board oversight at banks. In particular, this paper reviews the "fitness and propriety" (F&P) assessments that these jurisdictions use to ensure that bank board members are suitably qualified. It also surveys guidance on board composition and structure.

While all jurisdictions have imposed the F&P criteria, some authorities have no regulatory approval powers or do not require prior regulatory approval of board members in all cases. Three surveyed jurisdictions either have no powers to approve board candidates, or despite having such powers, do not require prior regulatory approval. In a few countries, only certain key directors are subject to regulatory approval, or prior regulatory approval is required only if the bank is in a troubled condition.

Of the two F&P criteria, the "fitness" criterion is more difficult to assess and the level of prescriptiveness varies across jurisdictions. In all surveyed countries, the "fitness" criterion contains at least four elements: general expertise; practical banking experience; time commitment; and conflicts of interest. Differences arise in the detailed definition of these factors. Some authorities prefer a principles-based approach, while others have issued more explicit guidance to shape their supervisory decisions. As one aspect of the fitness criterion, several jurisdictions are prescriptive on time commitment, by limiting the number of external directorships that board members can hold. Some countries also include an 'independence of mind' concept within the 'fitness' criterion, which considers the candidate's ability to challenge directors and senior management, mitigating the risk of "groupthink".

Interviews are used in several jurisdictions as part of the F&P assessment. Authorities that conduct interviews usually do so on a case-by-case basis, focusing primarily on key positions, such as the chief executive officer (CEO) or the board chair.

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Regulatory requirements on the board selection process are limited and, when guidance is provided, it is largely principles-based. Authorities may consider whether more prescriptive guidance is warranted, particularly where suboptimal governance outcomes continue to be observed.

As independent non-executive directors (INEDs) play a critical role on bank boards, all jurisdictions provide some guidance on independence. In determining independence, all surveyed jurisdictions specify when a director is <u>not</u> considered independent, by focusing on the relationship between a bank and a director. While the details vary, many jurisdictions prescribe at least a two-year time limit within which a person must not have engaged in such relationships. In addition, most countries have made the independence assessment time-bound by restricting the period a director can remain on a bank's board and still be considered independent.

Board composition is an area where authorities impose requirements to facilitate more effective representation. Nearly all authorities require the CEO and chair to be separate, with most requiring the chair to be either a non-executive director (NED) or an INED. Many countries also specify the number or percentage of the board that must be either INEDs or NEDs, while others mandate tenure limits for NEDs. Lastly, several countries set expectations on board diversity, with some establishing quotas to ensure sufficient female representation, and others requiring employee representation.

Minimum requirements for committee structures are prescribed. Authorities typically require banks to establish risk, audit and remuneration committees, while ethics and culture committees are rare. Variations exist in the level of prescription and composition of each committee.

The review of F&P assessment approaches identifies practices that may be useful for supervisory authorities. Authorities might consider, where appropriate, the following aspects: seek regulatory powers to approve board candidates; and determine whether aspects of the fitness criterion can be enhanced to help support desired outcomes. These include clarifying the "expertise" requirements of board candidates, particularly the board chair and the chair of board subcommittees; assessing the time commitment of board candidates, considering their outside obligations; incorporating the "independence of mind" concept, which goes beyond determining whether candidates have a conflict of interest; and outlining the role of interviews in the assessment process. In determining formal independence, supervisory assessments might be improved by defining more concrete attributes for an INED; establishing maximum INED tenure limits; and monitoring how often INEDs dissent from the majority opinion.

The stock-take also provides insights on the methods authorities use to enhance board composition and structure. Several initiatives may be contemplated, such as: clarifying the role of the CEO and Chair, including the circumstances when dual hatting are possible; specifying the desired percentage of NEDs and INEDs on boards and their committees; articulating mandated board committees and who can chair such committees, given their critical role in supporting board decisions; outlining the maximum tenure of NEDs; and delineating expectations on board diversity, to help mitigate against 'group think' and to expand the board's focus to a broader range of stakeholders.

While regulatory guidance on corporate governance is applicable to all banks, authorities differentiate expectations through the use of proportionality. In terms of the F&P criteria, the "fitness" component is where proportionality is applied, given that the expertise and time needed to serve on bank boards may vary according to the bank's risk, size and complexity. Some jurisdictions also apply proportionality in determining board composition and committee structures.

Lastly, it remains an open question whether proportionality is the best mechanism for addressing the unique corporate governance challenges that may arise from differences in bank ownership structures. In this context, state-owned banks and banks with diversified and concentrated ownership raise distinct corporate governance issues; and authorities may consider whether existing regulatory guidance is sufficient to address these challenges.