



FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

# Issues in Governance and Financial Stability

Seminar on Select Issues in Financial Stability

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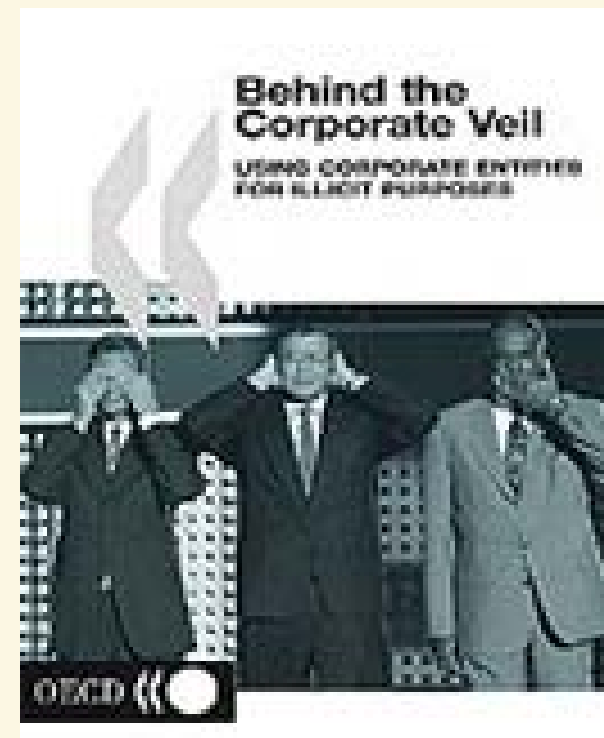
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## Why is corporate governance such a hot topic?

- Enron
- Allied Irish Bank
- Worldcom
- Parmalat
- Northern Rock
- Bear Stearns
- Lehman Brothers
- AIG
- and the list goes on!





## What is corporate governance?

- A process and structure used to
  - direct and manage a business
  - enhance shareholder value
  - ensure financial viability



## **Good governance protects:**

- Shareholders
- Employees
- Customers
- Public
- Supervisors



## Two simple but useful definitions

“Corporate governance relates to the internal means by which corporations are operated and controlled.”

*OECD*

“Corporate governance is the system by which companies are directed and controlled.”

*Cadbury Report, 1992*



## **Corporate governance and financial stability**

- You cannot have strong financial institutions without sound corporate governance
- You cannot have a stable financial system without strong financial institutions



## Corporate governance failures

- The recent financial crisis highlighted numerous issues related to corporate governance
- The UK parliament's Treasury Committee 2009 report on corporate governance and pay stated that “the current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives in the banking sector. Too often, eminent and highly regarded individuals failed to act as an effective check on, and challenge to, executive managers, instead operating as members of a cosy club.”



## Corporate governance failures

- According to Sir David Walker, three key areas need improvement:
  - the capability and dynamic of the board
  - board oversight of risk
  - engagement between bank owners and boards (especially institutional investors)
- “Boards fail individually and collectively despite excellent business awareness and acumen.”





## Corporate governance failures

- In his recent book, *The Financial Crisis*, Howard Davies highlights six key areas of board failure:
  1. Non-executive directors were the wrong people, with inadequate skills
  2. They spent too little time on their responsibilities
  3. They did not perform effective oversight of risk management
  4. They placed excessive reliance on internal advice and did not arm themselves with external, potentially contrary opinions
  5. They permitted compensation systems that drove dangerous risk-taking
  6. In the United States, the structure of boards was flawed (Chairman and CEO combined)



## Corporate governance failures

- At the time of its failure, Lehman Brothers had ten independent directors on its board
  - nine were retirees (four of whom were older than 75)
  - only two had ever worked in the financial industry
  - one was a former Navy Admiral who spent her entire career in human resources
  - one was a theatrical producer who sat on both the Audit Committee and the Finance and Risk Committee



## Work on corporate governance

- OECD
- Basel Committee on Banking Supervision
- The IMF and World Bank
- The Joint Forum
- Many national authorities



## Basel Committee guidelines

- Document issued in 1999; revised in 2006 and 2010
- Focuses on the unique issues related to banks and sets out the key elements of corporate governance for banks
- Draws on extensive supervisory experience
- The 2010 paper is based on 14 principles
- Applies to a wide range of banks and countries, and to diverse board structures
- Should be implemented in such a way as to be commensurate with bank size, complexity and risk profile



## Basel Committee guidelines

- Why do banks merit special attention?
  - Importance to the economy
  - Highly leveraged nature of their business
  - Increasing complexity of bank activities
  - Reliance on deposits for funding
  - High cost of bank failures
  - Failure of a bank may have systemic consequences



## 2010 Basel Committee guidelines

- Key areas of focus:
  - Board practices, qualifications and structure (1-4)
  - Senior management (5)
  - Risk management and internal controls (6-9)
  - Compensation (10-11)
  - Complex or opaque corporate structures (12-13)
  - Disclosure and transparency (14)



## 2010 Basel Committee guidelines

- Board practices:
  - Responsibilities of the board
  - Corporate values and code of conduct
  - Oversight of senior management
- Board qualifications
  - Qualifications
  - Training
  - Composition



## 2010 Basel Committee guidelines

- Board structure:
  - Organisation and functioning of the board
  - Role of the chair
  - Board committees
  - Conflicts of interest
  - Controlling shareholders
  - Board of parent company
  - Board of regulated subsidiary





## 2010 Basel Committee guidelines

- Senior management:
  - “Under the direction of the board, senior management should ensure that the bank’s activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.”



## 2010 Basel Committee guidelines

- Risk management and internal controls:
  - Risk management vs internal controls
  - Chief risk officer or equivalent
  - Scope of responsibilities, stature and independence of the risk management function
  - Resources and qualifications
  - Risk methodologies and activities
  - Internal communications
  - Effective use of the work of internal and external auditors, and internal control functions



## 2010 Basel Committee guidelines

- Compensation:
  - Board oversight of the compensation system's design and operation
  - Compensation should be aligned with prudent risk taking



## 2010 Basel Committee guidelines

- Complex or opaque corporate structures:
  - “know your structure”
  - “understand your structure”



## 2010 Basel Committee guidelines

- Disclosure and transparency:
  - “The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.”



## **Why should supervisors care about corporate governance?**

- Well run banks are obviously easier to supervise
- There should be a natural partnership between bank management and banking supervisors
- Supervisors are not supposed to be running banks
- Reduces supervisory vulnerability
- A well-managed financial system contributes to the public good



## 2010 guidelines – the role of supervisors

- Supervisors should:
  - provide guidance to banks on expectations for sound corporate governance
  - regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles
  - supplement their regular evaluation of a bank's corporate governance policies and practices by monitoring a combination of internal reports and prudential reports, including reports from third parties such as external auditors



## 2010 guidelines – the role of supervisors

- Supervisors should:
  - require effective and timely remedial action by a bank to address material deficiencies in its corporate governance policies and practices, and should have the appropriate tools for this
  - cooperate with relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices (MoUs, supervisory colleges, periodic meetings)





## Supervisory review process

- Traditional methods for monitoring corporate governance:
  - On-site examinations
  - Off-site surveillance
  - Periodic meetings with bank management
  - Review of work of internal and external auditors
  - Periodic reporting
- Supervisory follow-up



## On-site examinations - results

- Supervisors should ensure that all directors are aware of key findings of examinations
- Supervisors should meet with the Board of Directors to review examination findings, especially when there are problems
- In addition, they should consider supplying the directors with a summary report highlighting any significant problems or areas of concern



## Meetings with boards of directors

- Objectives are to:
  - foster a better understanding of the respective roles of directors and examiners
  - inform directors of the examination scope and the bank's condition
  - obtain information concerning future plans and proposed changes in policies that may have a significant impact on the future condition of the bank
  - obtain a commitment to initiate appropriate corrective action for any problems



## Off-site surveillance

- Ongoing off-site surveillance has the objective of identifying important issues at an early stage so that appropriate action is taken before major problems develop
- Supervisors should establish a principle that supervised institutions keep the supervisors informed of important issues on a timely basis (no surprises!)



## Off-site surveillance

- Supervisors should monitor:
  - overall financial condition of the bank, looking for signs of deterioration
  - reports filed on specific matters (large exposures, connected lending, etc)
  - follow-up by management to weaknesses detected during the examination process
  - changes in board, senior management and shareholders (over a certain percentage)



## Periodic meetings with bank management

- Supervisors should discuss:
  - overall strategy of the bank
  - any planned changes to activities/major acquisitions or divestitures
  - any deterioration in the bank's overall condition
  - any changes to board composition or senior management
  - management succession plan



## **Review of work done by internal and external auditors**

- Supervisors should evaluate the work of the internal audit department and, if satisfied, can rely on it to identify control problems or areas of potential risk
- Supervisors should discuss with the internal auditors the risk areas identified and corrective measures taken
- Whenever the head of internal audit is replaced, the supervisor should be informed by management



## **Review of work done by internal and external auditors**

- Supervisors and external auditors have similar concerns regarding the activities of banks
- The supervisor should make use of work conducted by the external auditor, as appropriate
- The supervisory authority should also be made aware of any serious problems detected by external auditors





## **Review of work done by internal and external auditors**

- Supervisors should:
  - review management reaction/follow-up to weaknesses detected by internal and external auditors
  - ensure that internal auditors report directly to the board or its audit committee
  - determine that there are no conflicts of interest



## Supervisory follow-up

- When corporate governance at a particular bank is deemed to be insufficient or ineffective, supervisors must ensure that corrective actions are taken promptly
- There is no room for supervisory “forbearance” when it comes to weaknesses in the governance of a banking institution



## Supervisory follow-up

- Possible supervisory actions include:
  - Mild (extra reporting, special exams/audits, etc.)
  - More punitive (fines, replacement of managers/board members, suspension of dividends)
  - Assignment of trustee/overseer
  - Revocation of licence



## Keeping corporate governance in context

- Impossible to legislate integrity
- “Independence” difficult to define
- Substance over form
- Leadership: board members and senior management as true role models



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## Questions

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