

REBUILDING BANK GOVERNANCE AFTER THE FINANCIAL CRISIS: BEST PRACTICES

THOMSON REUTERS

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Demands on bank directors have rarely been higher. Following the financial crisis of 2008, board members in the U.S. and Europe have confronted dozens of new rules from a multitude of regulators, while striving to regain the confidence of customers and shareholders.

Amidst this newfound scrutiny, bank boards are increasingly being held accountable, with regulators as well as private plaintiffs pursuing claims when performance falters. In the first nine months of 2012, the FDIC authorized suits against 274 defendants—although many of these will ultimately be settled.

The scrutiny shows no sign of abating. Just in the last few months, there has been the Libor rate-setting scandal that led to the resignation of Barclays chief executive, and the unexpected trading loss of more than \$5.8 billion at JPMorgan that was followed by the departure of its chief investment officer.

How should bank boards respond in these times of heightened risk? This white paper will review governance guidelines mandated by regulators or recommended by academics and consultants. The hope is that banks will be less vulnerable to extraordinary losses by setting clear standards for assessing risk; paying careful attention to board structure and selection of directors; and taking a thoughtful approach to incentive compensation for top executives.

WHY BANKS ARE DIFFERENT

Banks require governance solutions that differ from what other industries might adopt. This is due to banks' conflicting constituents: on the one hand, they must satisfy shareholders, but they are also beholden to the public, including depositors. Satisfying the first group may mean taking risks that jeopardize the second—which in turn could subject the bank to regulatory scrutiny. Being a bank board member involves a delicate search for a middle ground.

There is also a wider array of risks bank managements and boards must assess in contrast to other industries. These include credit; market; liquidity; operational; legal and reputational risks. At any time, one of these risks has the potential to jeopardize the bank's business—making it critical for board members to have timely access to information.

The regulatory scrutiny to which banks are subject, as well as the rising risk of litigation, makes it particularly important for banks to be able to point to an effective governance structure. For example, banks should give careful thought to what percentage of directors are 'inside' directors versus independent directors; what the appropriate board committees are to establish and of course, who is best equipped to run those committees. In particular, the board may want to consider a 'skills audit' to identify in greater detail what knowledge or experience each member can contribute to the board.

Bank directors should keep in mind that regulators conduct examinations that include an assessment of whether a board is carrying out its duties. During the course of an examination, examiners review board minutes. According to a guide for bank directors published by the Federal Reserve Bank of Kansas City (Basics for Bank Directors, January 2010), the examiner will look to the minutes to confirm that the board has: "approved business strategies for the bank; approved and reviewed policies that articulate risk tolerances and set exposure limits for its important activities; and periodically reviewed the bank's performance in order to monitor its risk exposures and the effectiveness of its risk management. Bank directors must also be mindful of "management information," or what information is disclosed to regulators and the public on business and risk decisions.

ESTABLISHING A FRAMEWORK FOR ASSESSING RISK

Given the growing complexity of global banks' operations, regulators have stressed that bank boards should be guided by a special committee focused on risk management, and set specific standards for that committee's priorities. The failure of bank boards to adequately monitor risk has been repeatedly referred to by regulators as a cause of the financial crisis. One oft-quoted fact about the collapse of Lehman Brothers is that the bank's risk committee met only twice in 2006 and in 2007, the years leading up to the crisis.

In the past, many bank boards managed risk through the audit committee. But that is changing, at the prodding of regulators who believe risk oversight is critical enough to warrant its own committee. The role of the risk committee is to take a strategic approach to analyzing and assessing risk. In contrast, the audit committee is responsible for verifying that the proper controls are in place, with regard to risk management, compensation and other governance issues. This is key given banks' increased disclosure requirements.

U.S. banks, along with other companies, are bound by enhanced Securities and Exchange Commission disclosure rules effective February 2010, requiring companies to provide details about the board's role in assessing risk. Even though the rule does not mandate a specific course of action, it indirectly promotes best practices in risk management. The rules also require companies to disclose compensation policies that could affect the company's risk profile.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 will require publicly traded U.S. bank holding companies with assets of \$10 billion or more to set up a

separate risk committee composed of independent directors, including at least one risk management expert with a background at a large, complex business. The Federal Reserve is currently drafting this rule; similar requirements for smaller bank holding companies may follow.

In the U.K., the Walker Review, an assessment of corporate governance at U.K. banks, was published in November 2009, strongly recommending that banks set up a board-level risk committee and appoint a Chief Risk Officer to support the board committee. However, the recommendations ultimately adopted in the revised UK Corporate Governance Code (affecting all companies) the following year did not mandate a separate risk committee. The code does stress that "the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives."

The Basel Committee on Banking Supervision, which includes representatives of 27 nations, published its revised 'Principles for Enhancing Corporate Governance' in October 2010. The principles noted that "effective risk management requires robust internal communication within the bank about risk, both across the organization and through reporting to the board and senior management." The Basel Committee also recommended the appointment of a Chief Risk Officer with access to the board, and in many cases, a risk committee.

Banks have already made progress in tightening risk controls: a recent survey by Ernst & Young (Progress in Financial Services Risk Management, June 2012) of 69 global banks and 6 insurance companies found that 87% already had established a board-level risk committee; while 57% of participants said their boards had increased focus on risk post-crisis.

FOCUSING ON THE RIGHT DATA REMAINS A CORE CHALLENGE

But more needs to be done, with information gathering cited as the top challenge. While 77% of participants in the Ernst & Young survey have increased spending on technology since the crisis, it will take years before those systems are fully operational.

“While the reporting process is improving in many organizations, persistent problems still cited run the gamut from poor data quality, to gaps in data flow from system to system, to the sheer volume of data, which can result in ‘phone book-sized’ reports that are not relevant or useful,” the study noted.

A key question is what data is important for the board to monitor. Boards are desperate to avoid getting overwhelmed by minutiae, at a time when rising complexity makes risk harder to monitor. Historically banks have focused on formulas such as Value At Risk to determine whether the bank was operating in a prudent manner. But critics say VAR failed to take into account extreme market conditions, such as those of 2008.

A useful description of how boards should approach risk management appeared in the Basel Committee report:

“Risk analysis should include both quantitative and qualitative elements. While risk measurement is a key component of risk management, excessive focus on measuring or modeling risks at the expense of other risk management activities may result both in overreliance on risk estimates that do not accurately reflect real exposures and in insufficient action to address and mitigate risks. The risk management function should ensure that the bank’s internal risk measurements cover a range of scenarios, are not based on overly optimistic assumptions regarding dependencies

and correlations, and include qualitative firm-wide views of risk relative to return and to the bank’s external operating environment. Senior management, and, as applicable, the board, should review and approve scenarios that are used in the bank’s risk analysis and should be made aware of assumptions and potential shortcomings embedded in the bank’s risk models.”

FINDING THE RIGHT PEOPLE – EXPERIENCE IS KEY, BUT NOT THE ONLY ANSWER

Even if boards obtain the appropriate data, interpreting it is another matter. As a result, identifying the best executives to serve on bank boards is a critical task.

Many third parties such as rating agencies maintain that bank boards should include directors with financial backgrounds. Given the risks at stake, it is no longer acceptable for bank directors to plead ignorance of arcane financial products such as collateralized bond obligations.

Banks have in fact been hiring more financial veterans. A report by Moody’s Investors Service (Bank Boards in the Aftermath of the Financial Crisis, March 2010) noted that 46% of outside directors at global banks in North America and Europe had financial backgrounds, up from 32% before the crisis.

Still, hiring banking industry veterans may not be a panacea. A Federal Reserve Bank of New York report on governance (Corporate Governance and Banks: What Have We Learned From the Financial Crisis?, June 2011) noted that the Bear Stearns board included seven directors with a financial background, out of a total of 13 members. Meanwhile, at Northern Rock, the British bank bailed out by the government in 2008, the board included a former bank CEO, a top fund manager, and

a prior member of the governing body of the Bank of England. Could it be, the report wondered, that more sophisticated board members actually enable risk taking?

Expertise has its place on bank boards, but perhaps it is more important to be mindful of structural standards. For example, shareholders are urging banks to move away from having one executive serving as both CEO and Chairman. Bank of America made the change back in 2009, after more than half of shareholders voted to strip then-CEO Kenneth Lewis from his dual role as Chairman. (Citigroup named an independent Chairman in 2010 but has reserved the right to place the CEO in the Chairman's seat, assuming it appoints a lead independent director.) Other large banks will likely follow: In April, 40% of JPMorgan shareholders voted to remove CEO Jamie Dimon from his role as Chairman.

So-called 'independent' directors who stay in those roles too long may lack objectivity, a World Bank report noted (Bank Governance: Lessons from the Financial Crisis, March 2010). For example, at the time of the financial crisis, non-executive bank directors had been in place ten years at Bear Stearns, and at Bear Stearns, Lehman Brothers and Merrill Lynch, the term of the CEO/Chairman exceeded those of non-executive directors.

A SPOTLIGHT ON EXECUTIVE PAY

Another focus of bank governance reform involves setting appropriate levels of incentive compensation. Many critics believe excessive pay contributed to the financial crisis. Compensation is also a hot-button issue for investors and customers, who get angry when executives get paid millions of dollars after a bank has suffered losses.

In June 2010, regulators overseeing most U.S. banks issued guidance requiring the largest

banks to be sure incentive compensation practices for their highest paid employees "take into account risk and are consistent with safe and sound practices."

Globally, a force for change in bank compensation policies has been the Financial Stability Board (FSB), set up after the financial crisis and whose members include the "Group of Twenty" plus Spain, the Netherlands, Switzerland, Singapore and Hong Kong, and the European Commission. The G-20 approved the Principles and the Implementation Standards set forth by the FSB on compensation in 2009, and FSB members are at various stages of implementation. (Both the European Union and the U.S., through Dodd Frank, have adopted much of the FSB principles).

The FSB mandates placing limits on a bank's bonus pool as a percentage of net revenues if the underlying capital base is not sound. For "material risk takers," the FSB calls for 40% to 60% of variable compensation to be deferred at least three years, with even more deferred for the most senior executives. Banks should "claw back" incentive compensation if performance suffers.

The FSB calls for over 50% of incentive compensation to be in the form of stock, or equity-linked securities, rather than cash—"as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk." Some observers note that an excessive focus on the stock price can, in fact, lead to increased risk taking. The chief executives at Bear Stearns and Lehman Brothers, for example, were among those institutions' largest shareholders. Some experts, including former top banking executive Sallie Krawcheck, in a recent Harvard Business Review article ("Four Ways to Fix Banks," June 2012) – suggest boards link at least some of the pay of top executives to the bank's debt.

Another trend affecting bank compensation involves shareholders' growing role. Following the passage of Dodd-Frank, all U.S. companies must include in their proxy a separate resolution called "Say on Pay" which allows investors to indicate their views on compensation plans. Companies in the U.K. have had the ability to comment on pay packages since 2003, although the government is expected to make such votes binding starting next year.

These shareholder votes are leading to increased scrutiny for bank executives. In April, a majority of Citigroup's shareholders voted against management's pay packages in a non-binding vote. Since then, the bank has reportedly hired a consultant to review the compensation. That same month, more than a quarter of Barclays shareholders voted against the compensation of its then-CEO, Robert Diamond. The bank agreed half of Mr. Diamond's £2.7m bonus for 2011, which was to be paid out over three years, would only be paid in full when the bank's return

on equity exceeded its cost of equity. (Mr. Diamond has since stepped down following the Libor scandal and agreed to forfeit much of his compensation).

CONCLUSION

Keeping a tight rein on risk at a bank in the twenty-first century is a complicated task. Setting the right framework for assessing risk, selecting the right board members, and determining the right compensation mix for top executives are all important. But given the growing complexity behind these processes, communication among board members and with top bank executives remains critical. A thoughtful board will be in frequent contact, with mechanisms in place to respond quickly in times of market stress, with the help of improved technology. Enhanced communication can go a long way toward identifying problems before they blossom into scandals or areas of regulatory scrutiny.



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