



# **TOWARD** EFFECTIVE GOVERNANCE *of* **FINANCIAL INSTITUTIONS**

**30**

Group of Thirty

*The views expressed in this report are those of the Working Group on Corporate Governance and do not necessarily represent the views of all individual members of the Group of Thirty.*

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*Copies of this paper are available for \$49 from:*

*The Group of Thirty*

*1726 M Street, N.W., Suite 200*

*Washington, D.C. 20036*

*Tel.: (202) 331-2472*

*E-mail: [info@group30.org](mailto:info@group30.org); [www.group30.org](http://www.group30.org)*

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APRIL 2012



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# ABBREVIATIONS

CEO	chief executive officer
CRO	chief risk officer
FI	financial institution
FSA	Financial Services Authority (UK)
FSB	Financial Stability Board
G30	Group of Thirty
HR	human resources
IT	information technology
OECD	Organisation for Economic Co-operation and Development
SIFIs	systemically important financial institutions

# FOREWORD

Weak and ineffective governance of systemically important financial institutions (SIFIs) has been widely cited as an important contributory factor in the massive failure of financial sector decision making that led to the global financial crisis. In the wake of the crisis, financial institution (FI) governance was too often revealed as a set of arrangements that approved risky strategies (which often produced unprecedented short-term profits and remuneration), was blind to the looming dangers on the balance sheet and in the global economy, and therefore failed to safeguard the FI, its customers and shareholders, and society at large. Management teams, boards of directors, regulators and supervisors, and shareholders all failed, in their respective roles, to prudently govern and oversee.

On the subject of governance as it applies to FIs, much has been written and said in the past few years. Notable among these statements are the 2009 Walker report (*A Review of Corporate Governance in UK Banks and other Financial Industry Entities*) and the Basel Committee's *Principles for Enhancing Corporate Governance* (2010). Many domestic regulators and stock exchanges have also weighed in with new requirements and guidelines for governance. The Group of Thirty (G30) applauds these prior initiatives and supports not only the spirit of their conclusions but also many of the detailed recommendations they contain. The combination of these reports, self-scrutiny by the firms themselves, and pressure from regulatory overseers has already yielded substantial changes in governance practice across the financial services industry and around the globe.

Why would the G30 wish to add its own voice to the body of work already available, in light of progress being made?

- ◆ First, no one should presume that FI governance is now fixed. It is true that boards are working harder; supervisors are asking tough questions and preparing for more intensive oversight; management has become much more attuned to risk management and to supporting the oversight responsibilities of the board; and shareholders, to some degree, are taking a deeper look into their role in promoting effective governance. Nevertheless, as this report highlights, highly functional governance systems take significant time and sustained effort to establish and hone, and the G30's input can help with that effort.
- ◆ Second, in a modern economy, business leadership represents a large concentration of power. The social externalities associated with the business of significant financial institutions give that power a major additional dimension and underscore the critical importance of good corporate governance of such entities.
- ◆ Third, we note that the prior reports and guidance almost always come from a national or regional perspective (the Basel Committee report being a notable exception), which is understandable as a practical matter, but curious given the distinctly global nature of the SIFIs, which are appropriately the focus of attention.

Accordingly, in late spring of 2011, the G30 launched a project on the governance of major



financial institutions. The project was led by a Steering Committee chaired by Roger W. Ferguson, Jr., with John G. Heimann, William R. Rhodes, and Sir David Walker as its vice-chairmen. They were supported by 11 other G30 members, who participated in an informal working group. Requests for interviews went out from the G30 to the chairs of 41 of the world's largest, most complex financial institutions—banks, insurance companies, and securities firms. In an extraordinary response, especially in light of the pressures on each of these companies, 36 institutions shared their perspectives and experiences through detailed discussions with board leaders, CEOs, and selected senior management leaders. In addition, the project team held discussions with a global cross section of FI regulators and supervisors. The majority of these interviews were conducted in person, all under the Chatham House Rule,<sup>1</sup> which encourages candor.

The report is the responsibility of the G30 Steering Committee and Working Group and reflects broad areas of agreement among the participating G30 members, who took part in their individual capacities. All G30 members (aside from those with current national official responsibilities) have had

the opportunity to review and discuss preliminary drafts. The report does not reflect the official views of those in policy-making positions or leadership roles in the private sector.

The report is wide-ranging in its coverage of the composition and functioning of FI boards and the roles of regulators, supervisors, and shareholders. The focus is on potentially universal core themes but acknowledges differences in customs and practice in different parts of the world. As regards approaches to total compensation, we do not address this subject in detail in this report; the G30 commends the Financial Stability Board's Principles for Sound Compensation Practices and fully supports their implementation.<sup>2</sup>

The G30 undertook its initiative on effective FI governance in the hope and expectation that FI board and senior management leaders could share actionable wisdom on the essence of effective governance and what it takes to build and nurture governance systems that work. We hope this report provides a measure of insight and sustenance to those with policymaking and operational responsibilities for effective governance in the world's great financial institutions.



Jacob A. Frenkel  
*Chairman of the Board of Trustees  
Group of Thirty*



Jean-Claude Trichet  
*Chairman  
Group of Thirty*

<sup>1</sup> The rule states that "When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed."

<sup>2</sup> The complete list of principles can be found at [http://www.financialstabilityboard.org/publications/r\\_090925c.pdf](http://www.financialstabilityboard.org/publications/r_090925c.pdf).



# ACKNOWLEDGEMENTS

On behalf of the entire Group of Thirty (G30), we would like to express our appreciation to those whose time, talent, and energy have driven this project to successful fruition. First, we would like to thank the members of the Steering Committee and Working Group, who guided the work at every stage and added their unique insight.

Special recognition must go to the men and women of the financial, regulatory, and supervisory institutions whom we interviewed, who generously and candidly shared their perspectives and experiences and whose insight constitutes the heart of this report. Participating financial institutions have their headquarters in 16 different countries on six continents. From all points on the globe, these senior leaders strongly testify to the role effective governance can play in securing the safety, soundness, and performance of the global financial system.

No project of this magnitude can be accomplished without the committed effort of a strong team. The G30 extends its deep appreciation to Tapestry Networks; project director Tom Woodard; and team members Mark Watson, Dennis Andrade,

and Christopher McDonnell. For this project, Tapestry Networks carried out the core research and drafted reports for review by the G30. They organized and conducted more than 80 interviews, the vast majority in person. In addition, the team drew on more than 70 additional interviews with directors, supervisors, regulators, and executives, conducted as part of Tapestry's normal course of business. Tapestry's work was conducted in collaboration with Ernst & Young LLP, under the leadership of Carmine DiSibio, vice-chair of global financial services; and William Schlich, global leader of banking and capital markets. The G30 is grateful for Ernst & Young's vital support. The G30 also thanks the other colleagues from around the world who provided their informal feedback to the text as it developed.

Finally, the coordination of this project and many aspects of report production had their logistical center at the offices of the Group of Thirty. This project could not have been completed without the efforts of executive director Stuart Mackintosh, Meg Doherty, and Emily McGrath of the G30.



Roger W. Ferguson, Jr.  
Chairman, Working Group on Corporate Governance



John G. Heimann  
Vice-chair



William R. Rhodes  
Vice-chair



Sir David Walker  
Vice-chair



# CORPORATE GOVERNANCE WORKING GROUP

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President and CEO, TIAA-CREF

Former Chairman, Swiss Re America Holding Corporation

Former Vice Chairman, Board of Governors of the Federal Reserve System

### Vice Chairmen

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Senior Adviser, Financial Stability Institute

Former U.S. Comptroller of the Currency

#### **William R. Rhodes**

President and CEO, William R. Rhodes Global Advisors

Senior Advisor, Citigroup

Former Senior Vice Chairman, Citigroup

#### **Sir David Walker**

Senior Adviser, Morgan Stanley International

Former Chairman, Morgan Stanley International

Former Chairman, Securities and Investments Board, UK

## WORKING GROUP

#### **Jacob A. Frenkel**

Chairman of the Board of Trustees,  
Group of Thirty

Chairman, JPMorgan Chase International

Former Chairman, Group of Thirty

Former Governor, Bank of Israel

Former Professor of Economics,

University of Chicago

Former Counselor, Director of Research,

International Monetary Fund

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Executive Secretary, Group of Thirty

President, Geoffrey Bell and Company, Inc.

#### **Guillermo de la Dehesa**

Director and Member of the Executive  
Committee, Grupo Santander

Former Deputy Managing Director,

Banco de España

**Richard A. Debs**

Advisory Director, Morgan Stanley  
Former President, Morgan Stanley International  
Former COO, Federal Reserve Bank of New York

**Arminio Fraga**

Founding Partner, Gávea Investimentos  
Chairman of the Board, BM&FBOVESPA  
Former Governor, Banco Central do Brasil

**Gerd Häusler**

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Former Managing Director and Vice  
Chairman, Lazard & Co.  
Former Counselor and Director,  
International Monetary Fund  
Former Managing Director, Dresdner Bank  
Former Member of the Board,  
Deutsche Bundesbank

**William McDonough**

Former Vice-Chairman, Bank of  
America Merrill Lynch  
Former Chairman, Public Company  
Accounting Oversight Board  
Former President, Federal Reserve  
Bank of New York

**Project Director**

**Thomas M. Woodard**, Tapestry Networks

**Guillermo Ortiz**

President and Chairman, Grupo Financiero Banorte  
Former Governor, Banco de México  
Former Chairman of the Board, Bank  
for International Settlements  
Former Secretary of Finance and  
Public Credit, Mexico

**Ernest Stern**

Partner and Senior Adviser, The Rohatyn Group  
Former Managing Director, JPMorgan Chase  
Former Managing Director, World Bank

**Ernesto Zedillo**

Director, Yale Center for the Study of Globalization  
Former President of Mexico

**Zhou Xiaochuan**

Governor, People's Bank of China  
Member of the Board of Directors, Bank  
for International Settlements  
Former President, China Construction Bank  
Former Assistant Minister of Foreign Trade

**Experts**

**William Schlich**, Ernst and Young

**Mark Watson**, Tapestry Networks

**Dennis Andrade**, Tapestry Networks

**Christopher McDonnell**, Tapestry Networks

**Jon Feigelson**, TIAA-CREF

**Stuart Mackintosh**, Group of Thirty

\* All the members participated in the project in their individual capacities. The views expressed do not necessarily reflect those of the institutions with which the members are affiliated.

# EXECUTIVE SUMMARY

What is meant by “governance” in the context of a financial institution (FI)?<sup>3</sup> Corporate governance is traditionally defined as the system by which companies are directed and controlled. The *OECD Principles of Corporate Governance* (2004) defines corporate governance as involving

*“a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”*<sup>4</sup>

In the case of financial institutions, chief among the other stakeholders are supervisors and regulators charged with ensuring safety, soundness, and ethical operation of the financial system for the public good. They have a major stake in, and can make an important contribution to, effective governance.

Good corporate governance requires checks and balances on the power and rights accorded to shareholders, stakeholders, and society overall. Without checks, we see the behaviors that lead to disaster. But governance is not a fixed set of guidelines and procedures; rather, it is an ongoing process by which the choices and decisions of FIs are scrutinized, management and oversight are strengthened and streamlined, appropriate cultures are established and reinforced, and FI leaders are supported and assessed.

## WHY GOVERNANCE MATTERS

The global economic crisis, with the financial services sector at its center, wreaked economic chaos and imposed enormous costs on society. The depth, breadth, speed, and impact of the crisis caught many FI management teams and boards of directors by surprise and stunned central banks, FI regulators, supervisors,<sup>5</sup> and shareholders.

Enormous thought and debate has gone into discovering what caused the global financial crisis and how to avoid another. In his much-quoted 2009 report on the causes of the crisis, Lord Adair Turner, chair of the UK’s Financial Services Authority (FSA), cited seven proximate causes: (1) large, global macroeconomic imbalances; (2) an increase in commercial banks’ involvement in risky trading activities; (3) growth in securitized credit; (4) increased leverage; (5) failure of banks to manage financial risks; (6) inadequate capital buffers; and (7) a misplaced reliance on complex math and credit ratings in assessing risk.<sup>6</sup> A critical subtext to these seven causes is a pervasive failure of governance at all levels.

More generally, most observers have agreed that a combination of “light touch” supervision, which relied too heavily on self-governance in financial firms, and weak corporate governance and risk management at many systemically important financial institutions (SIFIs) contributed to the

3 In this report, “financial institutions” are defined to include large banks, insurance companies, and securities firms.

4 Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (Paris: Organisation for Economic Co-operation and Development, 2004), 11.

5 We attempt throughout the report to distinguish the regulatory function from the supervisory function. The regulator sets the rules and regulations within which FIs are obliged to operate, while the supervisor oversees the actions of the board and management to ensure compliance with those rules and regulations. Confusion arises because both functions are often performed within the same institution (for example, the U.S. Federal Reserve and the UK Financial Services Authority).

6 Adair Turner, *The Turner Review: Regulatory Response to the Global Banking Crisis* (London: Financial Services Authority, 2009).

2008 meltdown in the United States. In several key markets, deregulation and market-based supervision were the political order of the day as countries vied for global capital flows, corporate headquarters, and exchange listings. Regulators also missed the potential systemic impact of entire classes of financial products, such as subprime mortgages, and in general failed to spot the large systemic risks that had been growing during the previous two decades.

In this context, boards of directors failed to grasp the risks their institutions had taken on. They did not understand their vulnerability to major shocks, or they failed to act with appropriate prudence. Management, whose decisions and actions determine the organization's risk status, clearly failed to understand and control risks. In many cases, spurred on by shareholders, both management and the board focused on performance to the detriment of prudence.

Effective governance is a necessary complement to rules-based regulation. The system needs both. Carefully crafted rules-based regulations concerning capital, liquidity, permitted business activities, and so forth are essential safeguards for the financial system, while effective governance shapes, monitors, and controls what actually happens in FIs.

Ineffective governance at financial institutions was not the sole contributor to the global financial crisis, but it was often an accomplice in the context of massive macroeconomic vulnerability. Effective governance can make a significant positive difference by helping to prevent future crises or by mitigating their deleterious impact. In other words, the rewards for investment in effective governance are great.

## A CALL TO ACTION

Each of the four participants in the governance system—boards of directors, management, supervisors, and (to an extent) long-term shareholders—needs to reassess their approach to FI governance and take meaningful steps to make governance

stronger. This report offers a comprehensive set of concrete insights and recommendations for what each participant needs to do to make FI governance function more effectively.

The G30 is acutely aware that the agendas of FI boards and supervisors are crowded, yet we urge them to continue to give effective governance one of their highest priorities.

- ◆ The financial sector needs better methods of assessing governance and of cultivating the behaviors and approaches that make governance systems work well. Board self-evaluation, especially when facilitated or led by an outside expert, can yield important insight, but it is sobering to consider that in 2007, most boards would likely have given themselves passing grades.
- ◆ Supervisors now aspire to understand governance effectiveness and vulnerabilities, but admit to having much to learn.
- ◆ Governance experts often describe what good governance looks like, but give little thought to how to measure or achieve high-performance results.

Given the role that inadequate governance played in the massive failure of financial sector decision making that led to the global financial crisis, it is natural that supervisors and stock exchanges are now paying great attention to governance arrangements. This attention, as a practical matter, often focuses on explicit rules, structures, and processes—best practices—that governance experts often believe are indicative of effective governance. Consequently, compliance with best practice guidelines has become very important to boards and to overseers charged with monitoring and encouraging good governance.

The G30 hopes this report will contribute meaningfully to the body of knowledge on governance and will be a useful tool for those tasked with shaping governance systems.

## THE ESSENTIAL QUESTION OF FUNCTION

*Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.*

Although the temptation to judge governance effectiveness by the extent of conformance to a set of perceived best practices can be overwhelming, it is also counterproductive. Most studies of governance agree that it is end behaviors, much more than frameworks and structures, that matter. “Box-ticking” neither improves governance nor accurately assesses it. Any arrangement can fail, but failures are more often caused by undesirable behavior and values than by bad structures and forms.

An examination of governance arrangements at 36 of the world’s largest FIs reveals a wide diversity of approaches, driven by differences in culture, law, institution-specific circumstances, the people involved, and precedent. This diversity is a good thing, since it means that the governance approaches are tailored to address the unique circumstances of each FI. Greater homogeneity would likely lead to poorer governance because the constraints that would have to be introduced to ensure homogeneity would reduce FIs’ freedom to optimize.

This suggests that all parties with a stake in the design, operation, and assessment of governance systems must concentrate on the essential question of function and let the issue of form recede.

Behavior appears to be key, and a focus on right behaviors means a shift from the “hardware” of governance (structures and processes) to the “software” (people, leadership skills, and values). This means asking questions such as: How does the board both engage and challenge management? How does it support management in overcoming key difficulties? Are interactions open and transparent? Does management help the board understand the real issues? What is the attitude of the CEO toward the board? Is the relationship between the CEO and the chair (where those roles are split) a constructive

one? Are issues presented to the board in a way that is amenable to the application of business judgment? What underlying organizational culture and values drive behaviors—and how can a desired culture best be supported and reinforced?

The art of governance is in making different forms function well and adjusting the form to enhance function. It takes mature leadership, sound judgment, genuine teamwork, selfless values, and collaborative behaviors—all carefully shaped and nurtured over time.

## THE BOARD

*Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy; the assessment of risk taking; and the assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy.*

The 2008–2009 financial crisis revealed that management at certain FIs, with the knowledge and approval of their boards, took decisions and actions that led to terrible outcomes for employees, customers, shareholders, and the wider economy. What should the boards have done differently? To answer that question, it is helpful to consider the mandate of boards.

Boards control the three key factors that ultimately determine the success of an FI: the choice of business model (strategy), the risk profile, and the choice of CEO—and by extension the quality of the top-management team. Boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk, and talent issues are making a critical mistake. Above all else, boards must take every step possible to protect against potentially fatal risks.

FI boards in every country must take a long-term view that encourages long-term value creation in the shareholders’ interests, elevates prudence without



diminishing the importance of innovation, reduces short-term self-interest as a motivator, brings into the foreground the firm's dependence on its pool of talent, and demands the firm play a palpably positive role in society.

The importance of mature, open leadership by a skillful board chair cannot be overemphasized. Effective chairs capitalize on the wisdom and advice of board members and management leaders and on the board's interactions with supervisors and shareholders, individually and collectively. Good chairs respect each of these vital constituents, preside, encourage debate, and do not manage toward a predetermined outcome.

## RISK GOVERNANCE

*Those accountable for key risk policies in FIs, on the board and within management, have to be sufficiently empowered to put the brakes on the firm's risk taking, but they also play a critical role in enabling the firm to conduct well-measured, profitable risk-taking activities that support the firm's long-term sustainable success.*

In the financial services sector more than in other industries, risk governance is of paramount importance to the stability and profitability of the enterprise. Without an ability to properly understand, measure, manage, price, and mitigate risk, FIs are destined to underperform or fail. Effective risk governance requires a dedicated set of risk leaders in the boardroom and executive suite, as well as robust and appropriate risk frameworks, systems, and processes.

The history of financial crises, including the 2008–2009 crisis, is littered with firms that collapsed or were taken to the brink by a failure of risk governance. The most recent financial crisis demonstrated the inability of many FIs to accurately gauge, understand, and manage their risks. Firms greatly

understated their inherent risks, particularly correlations across their businesses, and were woefully unprepared for the exogenous risks that unfolded during the crisis and afterward.

## MANAGEMENT

*Management needs to play a continuous proactive role in the overall governance process, upward to the board and downward through the organization.*

The vast majority of governance and control processes are embedded in the organizational fabric, which is woven and maintained by management. The board is dependent on management for information and for translating sometimes highly technical information into issues and choices requiring business judgment. Governance cannot be effective without major continuing input from management in identifying the big issues and presenting them for discussion with the board.

Management needs to strengthen the fabric of checks and balances in the organization. It must deepen its respect for the vital roles of the board and supervisors and help them to do their jobs well. It must reinforce the values that drive good behavior through the organization and build a culture that respects risk while encouraging innovation.

## SUPERVISORS

*Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.*

Supervisors have legally defined responsibilities relating to risk control; fraud control; and conformance to laws, regulations, and standards of conduct. Supervisors now seek a deeper and more

nuanced understanding of how the board works, how key decisions are reached, and the nature of the debate around them, all of which reveal much about the firm's governance. Most FI boards applaud this expansion in the supervisors' focus from control process details to include a broader grasp of issues and context. To be effective, however, this expansion requires regular interaction among senior people in supervisory agencies and boards and board members.

Supervisors need to broaden their perspectives to include FI strategy, people, and culture. They should focus their discussions with senior management and the board on the real issues—through both formal and informal communications. But they must also maintain their independence and accept that they will at best have an incomplete picture. Similarly, supervisors must not try to do the board's job or so overwhelm the board and management that they cannot guide the FI.

Supervisors have a unique perspective on emerging systemic, macroprudential risks and can compare and contrast one FI with others. This is vital information to develop and share.

Unfortunately, in the policy-making debate, the qualitative aspect of supervision is sometimes overshadowed by quantitative, rules-based regulatory requirements. Clearly, new capital, liquidity, and related standards are essential to a more stable global financial architecture, but enhanced oversight of the performance and decision-making processes of major FIs is also essential.

## SHAREHOLDERS

*Long-term shareholders can and should contribute meaningfully to effective FI governance.*

Shareholders can contribute meaningfully to the effective governance of FIs. Most institutional shareholders do not have seats on the board but

should nonetheless, to the extent possible, be active in oversight of governance, commensurate with their ownership objectives. Boards and management teams should be encouraged to engage seriously with shareholders, listen closely, and factor shareholder perspectives into decisions.

## VALUES AND CULTURE

*Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.*

Suitable structures and processes are a necessary but not a sufficient condition for good governance, which critically depends also on patterns of behavior. Behavioral patterns depend in turn on the extent to which values such as integrity, independence of thought, and respect for the views of others are embedded in the institutional culture.

In a great FI, positive values and culture are palpable from the board to the executive suite to the front line. *Values and culture drive people to do the right thing even when no one is looking.* Values and culture are a fundamental aspect of the governance system, which makes them legitimate and important dimensions of inquiry for supervisors. Values and culture are also important areas for consideration and inquiry by boards. While these soft features defy quantitative measurement, they cannot be ignored. Anyone spending time in an organization quickly develops a clear sense of what drives it: most new employees understand the values and culture of the institution within a year, and many figure it out within just a few months. They instinctively observe how values and culture influence day-to-day business decisions and personnel choices. Supervisors can do likewise.

## CHANGING THE WAY WE THINK ABOUT GOVERNANCE

The G30 is not the first to reach the conclusion that proper behaviors are the key to effective FI governance. But this report endeavors to describe those essential behaviors and to provide implementable ideas for engendering them.

The key to changing the way people *behave* is to change the way they *think*. Accordingly, the paramount aim of this report is to promote among board members, management leaders, supervisors, and shareholders a practical and productive way of thinking about effective governance. Only by changing the way people think about governance can we successfully induce the specific, tailored changes that will enhance governance in each institution.

For example, FI leaders would govern and supervisors and shareholders would assess governance differently if they believed the following:

- ◆ Governance is an ongoing process, not a fixed set of guidelines and procedures.
- ◆ Diversity of governance approaches across FIs is a virtue, not a vice.
- ◆ To get deeper and deeper into the details of all parts of the business may be a choice some boards will make, but endless detail is not a prerequisite for board effectiveness. Boards will need to dig deep selectively, as necessary for understanding.
- ◆ Board independence and challenge should bring a high quality and value-additive contribution to board deliberation and is not evidenced by the number of times a director says no to management.

- ◆ Having smaller boards that require greater time commitment from their members is a far better approach than having larger boards that require only modest time commitment.
- ◆ Non-executive directors, sometimes called “outside board members,” must bring an independent, external perspective.
- ◆ Effectively balancing risk, return, and resilience takes judgment. If a risk is too complicated for a well-composed board to understand, it is too complicated to accept.
- ◆ Management’s key governance mandate is to give the directors the best means of understanding the business issues upon which judgment is required.
- ◆ The best board in the world cannot counterbalance a weak internal control and risk management architecture.
- ◆ Supervisors need a deep and nuanced understanding of each FI’s strategy, governance approach, culture, leaders, and issues.
- ◆ Institutional shareholders will not prevent the next crisis, but they can and should engage more productively in governance matters.
- ◆ Values and culture are the ultimate “software” that determines the behaviors of people throughout the FI and the effectiveness of its governance arrangements.

The list above is not comprehensive. The body of the report contains a host of insights and recommendations with the potential to shape thinking on effective governance.

\* \* \*

## REPORT STRUCTURE AND CORE MESSAGES

This report is composed of seven chapters, preceded by a list of key recommendations. The chapter subjects and messages are as follows.

1. Addressing the essential question of function
  - ◆ Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.
2. The vital role of boards of directors
  - ◆ Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy; assessment of risk taking; and the assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy.
3. Risk governance: A distinctive and crucial element of FI governance
  - ◆ Those accountable for key risk policies in FIs, on the board and within management, have to be sufficiently empowered to put the brakes on the firm's risk taking, but they also play a critical role in enabling the firm to conduct well-managed, profitable risk-taking activities that support the firm's long-term sustainable success.
4. Deep commitment to governance: A requirement from management
  - ◆ Management needs to play a continuous proactive role in the overall governance process, upward to the board and downward through the organization.
5. The role and responsibility of supervisors
  - ◆ Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.
6. Relationships between FI boards and long-term shareholders
  - ◆ Long-term shareholders can and should contribute meaningfully to effective FI governance.
7. The impact of values and culture on behaviors and decisions
  - ◆ Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.



# INSIGHTS AND RECOMMENDATIONS *for* ENHANCING GOVERNANCE EFFECTIVENESS *of* FINANCIAL INSTITUTIONS

## THE ESSENTIAL QUESTION OF FUNCTION

*Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.*

1. *Diversity in governance approaches reflects unique circumstances.* Everywhere, from the United States to Europe to China to Brazil to Australia, there is convergence around the core roles of the board, management, supervisors, and shareholders. However, the specifics of those roles vary substantially from firm to firm, and from country to country, sometimes subtly and sometimes quite starkly. FIs tailor their specific model to optimize effectiveness under unique circumstances.
2. *Governance systems are defined by both hardware and software.* Governance systems are built around a defined architecture comprising both “hardware” (for example, organization structures and processes) and “software” (for example, people, skills, and values). The software makes the hardware function.
3. *Effective governance depends on people and how they interact.* Effective governance comes down to people and how they interact, whether in the boardroom, board committee meetings, management meetings, or meetings with supervisors and shareholders. FIs need to adopt good governance practices, and they can learn from the experiences of others, but what works best in one situation may not work at all in another. FIs can tailor governance arrangements, but if they have the wrong people, or if those people behave in dysfunctional ways, the arrangements do not matter.

## THE BOARD

*Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy; assessment of risk taking; and assurance that the necessary talent is in place, starting with the CEO, to execute the strategy.*

Well-functioning boards scrupulously discharge the following 10 essential tasks:

1. *Fashion a leadership structure that allows the board to work effectively and collaboratively as a team, unified in support of the enterprise.* Structures differ from one FI to another. There is no ideal template. Boards with 8 to 12 members are best positioned to encourage candor and facilitate constructive debate.
2. *Recruit members who collectively bring a balance of expertise, skills, experience, and perspectives and who exhibit irreproachable independence of thought and action.* Members with experience in the CEO role, in finance, and in regulation are particularly valuable. Credentials notwithstanding, interpersonal chemistry is an essential determinant of a board’s success.
3. *Build, over time, a nuanced and broad understanding of all matters concerning the strategy, risk appetite, and conduct of the firm, and an understanding of the risks it faces and its resiliency.* All board members should receive structured induction and ongoing training. The clear trend toward deeper engagement between directors and management and between directors and external constituents is to be applauded.

4. *Appoint the CEO and gauge top talent in the firm, assuring that the CEO and top team possess the skills, values, attitudes, and energy essential to success.* A very good CEO is preferable to a “star” CEO. The board must confirm the appointment of independent members of the executive team, including the chief risk officers (CROs) and head of internal audit, and should be consulted with respect to other very senior appointments. Boards should maintain a focus on talent development and succession planning, which are critical components of organizational stability.
5. *Take a long-term view on strategy and performance, focusing on sustainable success.* The board has an inviolable commitment to the long-term success of the firm, which should be viewed in a five-to-20-year time frame.
6. *Respect the distinction between the board’s responsibilities for direction setting, oversight, and control, and management’s responsibilities to run the business.* It is misguided and dangerous to conflate the responsibilities of management with those of the board. The board’s primary responsibilities include: (a) reaching agreement on a strategy and risk appetite with management, (b) choosing a CEO capable of executing the strategy, (c) ensuring a high-quality leadership team is in place, (d) obtaining reasonable assurance of compliance with regulatory, legal, and ethical rules and guidelines and that appropriate and necessary risk control processes are in place, (e) ensuring all stakeholder interests are appropriately represented and considered, and (f) providing advice and support to management based on experience, expertise, and relationships.
7. *Reach agreement with management on a strategy and champion management once decisions have been made.* There is an important role for the board in strategy, but the real development and analysis is clearly an executive function. The board challenges and discusses the proposal with management, revisions are made, details are discussed, and eventually a strategy is hammered out to which all are fully committed.
8. *Challenge management, vigorously and thoughtfully discussing all strategic proposals, key risk policies, and major operational issues.* Effective challenge demands integrity on the part of both the board and management. Management must accept the board’s prerogatives and respond positively rather than defensively. Boards must be careful not to undermine their own processes with disingenuous motives. Board members who challenge just to have their challenge recorded are not acting in the interest of the institution.
9. *Ensure that rigorous and robust processes are in place to monitor organizational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations. Proactively follow up on potential weaknesses or issues.* Oversight and compliance are important functions of the board, but boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk governance, and talent issues make a critical mistake.
10. *Assess the board’s own effectiveness regularly, occasionally with the assistance of external advisers, and share this assessment with the lead supervisor.* Boards should conduct periodic self-evaluations that include candid and constructive feedback on the performance of directors and committees. They should discuss the findings with their supervisors. Supervisors’ judgments regarding governance effectiveness are better informed with a rich understanding of the board’s internal findings.



## RISK GOVERNANCE

*Those accountable for key risk policies in FIs, on the board and within management, must be sufficiently empowered to put the brakes on the firm's risk taking, but they also must enable the firm to conduct well-managed, profitable risk-taking activities that support the firm's long-term sustainable success.*

Effective risk governance within FIs requires several actions on the part of boards and management teams:

1. *Establish a board-level risk committee that supports the board's role in approving the firm's risk appetite and that oversees the risk professionals and infrastructure.* The risk committee's core mission should be to shape the firm's risk appetite within the context of the firm's chosen strategy and then to present it to the full board for approval. It must ensure the risk culture supports the desired risk profile and must ensure risk leaders and professionals are capable, empowered, and independent. It must also ensure the firm has the necessary risk infrastructure in place.
2. *Ensure the presence of a CRO who is independent, has stature within the management structure and unfettered access to the board risk committee, and has the authority to find the appropriate balance between constraint and support of risk taking.* The CRO must have the independence, skills, and stature to influence the firm's risk-taking activities. The board should approve the appointment of the CRO, and the risk committee should annually review the CRO's compensation.
3. *Determine a risk appetite that is clearly articulated, properly linked to the firm's strategy, embedded across the firm, and which enables risk taking.* The FI's risk appetite framework should frame the choices regarding risks in terms of the type of institution the board and management are trying to build and sustain, and it should clearly link risks and returns. To be fully effective, the risk appetite framework must be embedded deep within the firm and linked to key management processes, such as capital allocation decisions, new product and businesses approvals, and compensation arrangements.
4. *Actively assess and manage the risk culture so that it supports the firm's risk appetite.* The risk committee and full board play a critical role, with management, in ensuring that the risk culture is consistent with the firm's risk profile aspirations. The tone set at the top of an FI is important, but non-executive directors also need to be attuned to the culture deep in the organization and how the messages at the top are communicated and interpreted by employees. They should seek out the views of supervisors and the external auditor.
5. *Ensure directors have access to the right level of risk information so as to see and fully comprehend the major risks.* FI management must strike a balance between being thorough and concise in reporting to the board. They must avoid overwhelming directors with details, while still providing sufficient and unbiased risk information.
6. *Maintain robust risk information technology (IT) systems that can generate timely, comprehensive, cross-geography, cross-product information on exposures.* Ultimately, the quality of risk information that FI boards and management teams receive depends largely on the quality of the organization's IT systems. Ideally, FIs need risk IT systems that can gather risk information quickly and comprehensively, producing estimates of their exposures within hours.
7. *Maintain an ongoing focus on emerging risks by having a holistic, vigilant view of all major risks, strategic and product creep, excess complexity,*

*and areas of overperformance.* Boards should take a broad perspective when overseeing risk, including operational and reputational risks that are difficult to measure and mitigate. They should look for early warning signs of emerging risks arising from increasingly complex organizational structures and products or businesses with unexpected overperformance.

8. *Strengthen the firm's ability to withstand exogenous shocks, recognizing that it is impossible to avoid financial stresses when they come.* No FI is resistant to all possible crises, but judicious advance planning and testing increases institutional robustness. Boards and management teams should also examine how their firms have reacted to actual unanticipated events in the past, since historic reactions can be very informative about the firm's resiliency.

## MANAGEMENT

*Management needs to play a continuous proactive role in the overall governance process, upward to the board and downward through the organization.*

For management to play its governance role effectively, it must take the following actions:

1. *Be accountable for the daily effectiveness of the control architecture.* Management must establish a control framework designed to prevent problems, actively monitor the firm on an ongoing basis, and aggressively address issues that arise. Management must ensure employees and executives adhere to company policy on routine decisions. The control framework should be able to elevate issues that fall outside the policy so that individuals do not navigate around policies without proper guidance and supervision.
2. *Ensure control professionals maintain a comprehensive view of the firm's risks, balancing*
- prudence with encouragement of sustainable risk taking.* Strong controls require independent control professionals. In some instances, they need veto rights. They should not be seen as a police force, however, and they need to enable controlled risk taking as well as constrain it.
3. *Educate and inform directors on an ongoing basis.* The most important thing management can do to foster good governance is to give the board a reasonable chance of understanding the company strategy, risk appetite, and major challenges the company faces. Management must effectively orient new directors and educate all directors on an ongoing basis to enable the board to ask critical questions of management.
4. *Focus the governance dialogue on the key issues and bring the board early into management's thinking on key decisions.* Governance only works if management has a process for identifying the major issues and presenting them to the board for discussion. Management must be unfailingly attentive to potential new agenda items for the board and its committees and must facilitate effective, ongoing communication between the board and management on key decisions.
5. *Expose directors to a broad set of executives and employees, both informally and formally, so they get an unfiltered view of the company.* Nothing should hinder communication between directors and executives. Directors should be free to talk to the executives, and they should feel confident and comfortable in doing so—the board-management relationship requires no less. However, directors should exercise the privilege of interaction with management with care.
6. *Work continually on modeling and supporting a culture that promotes long-term thinking, discipline, and accountability.* In addition to explaining what is expected of employees, members of management should model the

desired behaviors. Boards and management should articulate the foundational principles or values of the culture and foster their acceptance.

7. *Encourage a culture of no surprises, the quick elevation of issues, toleration of mistakes, organizational learning, and punishment of malfeasance.* Management must be open and transparent with the board and should promote those qualities throughout the organization. Only when management teams share their concerns openly, and in a timely fashion, can the board understand the issues and provide input or direction.
8. *Build a trust-based environment that supports critical challenge and is open to change.* Executives have to be prepared for tough questioning and must understand that it is the board's duty to challenge them. Executives must be ready for the board to reject a proposal. Being open to challenge is a sign of quality management. Constructive challenge is everyone's responsibility and should be fostered across the organization, upward and downward.

## SUPERVISORS

*Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.*

To enable supervisors to play a fully effective role in the overall governance process, they need to:

1. *Understand the overall business, strategy, and risk appetite of each FI, and focus on FI reactions to real-world events.* The expanded objectives of many supervisors encourage them to better understand the strategies, business plans, products, and risk appetite of the FIs they supervise. Supervisors should continue to improve the use of stress testing and horizontal reviews, but they should also learn how FIs have reacted to real-world events. Supervisors should look for areas where FIs are performing unexpectedly well and consider the sustainability of that performance.
2. *Develop a sophisticated appreciation of how corporate governance works, including governance structures and processes, board composition and new director selection, and the internal dynamics of effective FI boards.* Supervisors should seek to understand how effective governance and board challenge occurs in each FI, but supervisors should also safeguard their independence, attending board and committee meetings only occasionally. They can reserve the right to vet and approve new directors, as may be legally required, while leaving board building to the board chairman and nominating committee.
3. *Develop trust-based relationships with senior executives and directors by regularly engaging them in an informal dialogue on industry benchmarks, emerging systemic risks, and supervisory concerns.* Supervisors' increasing interaction and dialogue with senior executives and directors on key strategy, risk, and governance issues is a positive trend.
4. *Ensure boards and management govern effectively by setting realistic expectations of FI boards and adjusting regulatory guidance accordingly.* Regulatory guidance should clearly articulate distinct roles and expectations for FI boards and management. As supervisors develop a deeper understanding of the culture and values that drive behaviors in FIs, they will be better positioned to discuss their concerns or recommendations with FI leaders.
5. *Avoid overstepping their supervisory role and allow the board and management to shoulder their respective responsibilities.* As supervisors expand the scope of their oversight, they should

reserve the right to step into decisions historically left to management and boards if they determine that those decisions present undue risk with potential systemic consequences. However, they must do so only as a last resort. More frequent intervention risks compromising the clear fiduciary responsibility of management and the board.

## SHAREHOLDERS

*Long-term shareholders can and should contribute meaningfully to effective FI governance.*

To foster good relationships with shareholders, FIs need to engage in the following practices:

1. *Actively listen to shareholder perspectives and concerns before issues arise and communicate clearly the board's philosophy on governance matters of shareholder interest, including compensation, succession, and board composition.* Dialogue with investors is critical. By engaging in active communication, boards will stay abreast of shareholder concerns, will be aware of the mood of the investor community, and will be in a position to preempt unwelcome shareholder resolutions through dialogue and early action.
2. *Recognize that shareholders are a heterogeneous group and make every effort to honor shareholders' desire to be heard.* Shareholders have diverse interests and perspectives. The wise board must understand divergent objectives and strike the right balance for the long-term success of the institution.
3. *Thoughtfully manage their interactions with shareholders in the interest of clarity of message.* Most FIs routinely involve only a small handful

of non-executive directors in shareholder conversations, which is a reasonable approach. Discussions with shareholders need to be consistent, and the possibility of confusion or ambiguity increases as the number of voices in the process goes up.

4. *Decide when to resist shareholder demands, including those raised by proxy advisers, and when to accede to them.* Not all shareholders will be happy with the firm's governance philosophy and plans. Unhappy shareholders may file or threaten to file resolutions at the annual meeting. The board must choose and defend a position in the long-term interests of the institution, which is its primary responsibility, even though that position may sometimes run contrary to the wishes of certain shareholders.

The following points are also worth noting:

5. *The UK's Financial Reporting Council has put forward a useful shareholder code,<sup>7</sup> and the International Corporate Governance Network is supporting similar work.* Institutional investors globally would do well to carefully consider the work of both organizations. They should comply with the Financial Reporting Council's Stewardship Code whenever compliance is consistent with the investor's aims and the constraints under which it operates.
6. *Shareholders have an important role to play in shaping governance arrangements at FIs.* Shareholders can ask probing questions about governance, offer helpful observations, and otherwise support the FI. They not only have a right to be heard, they have an important voice in the governance process.

7 The UK Stewardship Code can be found at <http://www.frc.org.uk/corporate/investorgovernance.cfm>.

## VALUES AND CULTURE

*Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.*

Although values and culture cannot always be measured quantitatively, they impact governance effectiveness in powerful ways and therefore should be a major focus for the supervisor. The following views and recommendations highlight the importance of values and culture and the hard work involved in getting them right:

1. *Honesty, integrity, proper motivations, independence of thought, respect for the ideas of others, openness/transparency, the courage to speak out and act, and trust are the bedrock values of effective governance.*
2. *It is for the board of directors to articulate and senior executives to promote a culture that embeds these values from the top to the bottom of the entity. Culture is values brought to life.*
3. *Well-functioning boards set, promulgate, and embed these values, commonly in the form of a code, so that directors, senior executives, and all other employees in an entity are fully aware of the standards of behavior that are expected of them.*
4. *Because of their power to influence behavior and the execution of the FI's strategy, values and culture are essential dimensions of inquiry and engagement for supervisors. Major shareholders or their fund managers should be attentive to the culture of an entity when making investment decisions and engaging with an investee board.*



## CHAPTER 1

# *Addressing the Essential Question of Function*



*Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.*

FI governance aims to support the long-term success of the entity and ensure that vigorous entrepreneurial initiative is kept in line by a set of checks and balances so that the legitimate goals of all stakeholders are represented, balanced, and satisfied to the fullest extent possible. Many methods can be successful: a study of governance arrangements at 36 of the world's largest FIs reveals a wide diversity of approaches, driven by differences in culture, law, institution-specific circumstances, the people involved, and precedent.

This report focuses primarily on the governance of unitary boards, but the same elements that are critical to effective governance arise equally for two-tier boards, albeit within a different structure. These prominently include the quality of strategic review, the quality of the decision making on risk appetite, and maintenance of appropriate relationships with the supervisor and major shareholders.

While key processes differ in two-tier boards in Germany, Switzerland, and the Netherlands, a generic characteristic of governance in two-tier boards is that the greater the confinement of the supervisory board role to one of monitoring, the greater will be the reliance placed on the executive board for decisions on matters of strategy, risk appetite, and supervisory and shareholder relationships.

Any approach has the potential for failure, but these failures are more often caused by defective behavior or values than by bad structures or forms.

A governance system should be judged by how well it functions. A functional governance system requires the following elements:

- ◆ A *board of directors* that carries out its vital role
- ◆ A set of *management* protocols for governing and controlling operations in huge and complex

organizations that assures clear management accountability

- ◆ A constructive and rigorous *supervisory arrangement*
- ◆ *Shareholders* who have an appropriate voice and who exercise their rights and obligations.

## DIVERSITY IN GOVERNANCE APPROACHES REFLECTS UNIQUE CIRCUMSTANCES

Around the world, there is convergence regarding the core roles of the board, management, supervisors, and shareholders, and general consensus on the responsibilities inherent in good governance. For example, it is generally agreed that effective governance requires that shareholders meet periodically and have the ability to elect independent directors; that the board of directors be competent, engaged, and capable of challenging management and replacing the CEO, if necessary; that there be rigorous risk controls independent from the revenue producers in management, and processes that ensure compliance with applicable laws and regulations; and that those processes and information be transparent to supervisors and board members.

However, the way this works varies substantially from firm to firm, sometimes subtly and sometimes quite starkly. For example:

- ◆ Unitary boards (for example, in North America) operate very differently from two-tier boards (for example, in Germany, Switzerland, and the Netherlands). Additional board structures play a key role in China, Italy, and Japan. These approaches have been examined in great detail over the years, optimized, and found to be “fit for purpose.”

- ◆ How to configure the leadership of the board (that is, how best to distribute roles and responsibilities among the CEO, chair, vice-chair, and lead or senior independent director) has been thoroughly debated. Studies prompted by the financial crisis have found no correlation between the model chosen and relative success.
- ◆ Board size varies from fewer than 10 members to more than 20.
- ◆ Board composition (skills, number of executive directors, diversity) varies. FIs strike a balance among the many competing goals in a tight market for talent in many different ways.
- ◆ Depth of directors' engagement and the concomitant time required of them and of the board chair vary substantially. The bare minimum time required of a non-executive director has increased markedly; a requirement of 40 to 50 days a year is not unusual. Some governance approaches require far more time.
- ◆ Depth of supervisors' engagement, including their role in vetting and approving management leaders and board members, their participation in board meetings, and their mode of interaction with management and the board vary.

Although to some, this diversity may seem untidy, it arises from the need to deal with unique circumstances. Greater homogeneity might in some cases result in poorer governance because the constraints that would have to be introduced to bring about homogeneity would reduce FIs' freedom to optimize.

## **GOVERNANCE SYSTEMS ARE DEFINED BY BOTH HARDWARE AND SOFTWARE**

An analogy from information systems is informative for understanding governance systems. Both information and governance systems are built around a defined architecture. Each comprises certain “hard”

components (hardware) and “soft” components (software). The software enables the hardware to function.

- ◆ In the case of FI governance systems, the hardware includes the organizational structures and processes involved in governance. Many of these architectural features are described in governance guidelines and are amenable to check-the-box confirmation. For example: Does the board have a risk committee? Is there a chief risk officer, independent of line-of-business heads? Is there a duly constituted board, and does it include independent, non-executive directors? Does the board receive complete and timely information? Is there a division of responsibilities at the top of the company (that is, a chair/CEO split)? Is there a formal process for appointment of new directors? Is a board assessment process in place? Are risk control processes in place? Does the board disclose its remuneration policy? Does the board communicate with shareholders? A positive answer to all these questions, while encouraging, says very little about whether governance actually functions effectively.
- ◆ FI governance software comprises the arts, skills, and people that make the hardware functional. Judgments regarding the software's efficacy are often subjective and based on observations that are not always easy to make. For example: Does the board engage with and challenge management? Are interactions open and transparent? Does management give the board a reasonable chance of understanding the real issues? Is the CEO's attitude toward the board respectful and open? Is the relationship between the CEO and the chair (where those roles are split) a constructive one? Are issues presented to the board in a useful, practical manner conducive to the application of business judgment? Does the supervisor understand how a board works?

Affirmative answers to these questions tend to be good predictors of governance effectiveness.

The overall performance (effectiveness) of the system is determined by the combination of hardware and software. They must function coherently and drive the desired behaviors. A change in one component will cause changes in the others.

## **EFFECTIVE GOVERNANCE DEPENDS ON PEOPLE AND HOW THEY INTERACT**

It can be tempting, when one finds an FI with an effective governance system, to hold it up as a model for others to emulate. But unique circumstances make that tricky. Adopting another FI's governance best practice may not necessarily be advisable, because what works best in one situation may not work at all in another.

Effective governance comes down to the people in the room and how they interact, whether that interaction is taking place in the boardroom, board committee meetings, management meetings, or meetings with supervisors and shareholders. FIs can tailor

and optimize governance arrangements, but if they have the wrong people, or if those people behave in dysfunctional ways, the arrangements will not save them. Leadership makes a huge difference.

\* \* \*

The art of governance is in making different forms function well and adjusting the form to enhance function. It takes mature leadership, genuine teamwork, selfless values, and collaborative behaviors—all carefully shaped and nurtured over time. There is no blueprint that is a panacea, but the following chapters of this report, which draw on extensive discussions of unprecedented scope and breadth with FI leadership from across the globe, describe governance principles and generally accepted good practices that can apply to all FIs.

The G30 believes the insights and recommendations in each of the remaining six chapters will be of assistance to boards, management, supervisors, regulators, and shareholders as they grapple with how to assess and enhance the efficacy of corporate governance structures and culture within their firms.

## CHAPTER 2

# *The Vital Role of Boards of Directors*

*Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy, assessment of risk taking, and assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy.*

For many people, corporate governance is synonymous with the board of directors, which, indeed, can be thought of as the nexus of governance, given its management oversight and control function and its fiduciary responsibilities to stakeholders.

During the 2008–2009 financial crisis, management at certain FIs, with the knowledge and approval of their boards, took decisions and actions that led to terrible outcomes for employees, shareholders, and the wider economy. Several of those FIs no longer exist or have been absorbed by others, and some have been put under conservatorship or temporary government control as a consequence of egregious failures of judgment and, in many cases, the failure of effective governance. What should their boards have done differently? To answer that question, it is helpful to consider what is the mandate of boards.

Well-functioning boards scrupulously discharge the following 10 essential duties:

1. Fashion a leadership structure that allows the board to work effectively and collaboratively as a team, unified in support of the enterprise.
2. Recruit members who collectively bring a balance of expertise, skills, experience, and perspectives and who exhibit irreproachable independence of thought and action.
3. Build, over time, a nuanced and broad understanding of all matters concerning the strategy, risk appetite, and conduct of the firm, and understanding of the risks it faces and its resiliency.
4. Appoint the CEO and gauge top talent in the firm, assuring that the CEO and the top team possess the skills, values, attitudes, and energy essential to success.
5. Take a long-term view on strategy and performance, focusing on sustainable success.
6. Respect the distinction between the board's responsibilities for direction setting, oversight, and control, and management's responsibilities to run the business.
7. Reach agreement with management on a strategy and champion management once decisions have been made.
8. Challenge management, vigorously and thoughtfully discussing all strategic proposals, key risk policies, and major operational issues.
9. Ensure that rigorous and robust processes are in place to monitor organizational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations. Proactively follow up on potential weaknesses or issues.
10. Assess the board's own effectiveness regularly, occasionally with the assistance of external advisers, and share this assessment with the lead supervisor.

These 10 determinants of board effectiveness are discussed in depth below.

## 1. FASHION A LEADERSHIP STRUCTURE THAT ALLOWS THE BOARD TO WORK EFFECTIVELY AND COLLABORATIVELY AS A TEAM, UNIFIED IN SUPPORT OF THE ENTERPRISE.

When considering necessities for an effective board, the importance of a skillful chair's mature, open leadership cannot be overemphasized. Effective chairs manage to get the very best out of the members, individually and collectively. They respect the members, preside, encourage debate, and do not manage toward a predetermined outcome. As for the board as a whole, successful boards work well as a team, in the fullest sense of that word, achieving far greater impact than could a well-meaning collection of talented individuals working on their own. The choices of leadership structure and board size are important.

### Leadership structure

The leadership structure of boards varies substantially across countries and companies. Structure includes defining the roles of the chairman and CEO; establishing committees and their charters; and defining additional roles, such as vice-chair(s), deputy chair(s), senior independent director, and lead or presiding director.

### *Roles of the chairman and CEO*

Splitting the role of chairman and CEO has become the most common practice globally. A combined chair/CEO is not permitted by law in some countries.

There is compelling logic for splitting the two roles:

- ◆ If the job of the board is to control management, then an irresolvable conflict of interest arises when the most powerful board member (the chair) is also the most powerful member of management (the CEO).

- ◆ In a complex, global FI, the responsibilities of chairing the board constitute a substantial workload, requiring a minimum of 35 percent time commitment, and typically much greater. Meanwhile, the pressures and breadth of responsibility borne by the CEO have grown almost beyond the capacity of a single person. To ask one person to ably fulfill both the role of CEO and the role of chair seems unreasonable.
- ◆ Combining roles concentrates too much power in a single person.

Splitting the roles is strongly encouraged. A combined role may be acceptable if the board appoints a lead or senior independent director with the responsibility and authority to act as though he or she were the non-executive chairman under circumstances that call for greater independence. It is worth noting that the majority of examples of the combined role are found in the United States.

### *Responsibilities, time commitments, and additional roles*

Where the board chair and CEO roles have been split, one observes a broad spectrum of approaches to the chair's core responsibilities and the time required to fulfill those duties. In general, the board chair, the lead director, and committee chairs are required to spend more time in their roles than is required of other board members. This is a generally accepted good practice and should be encouraged in all FI boards.

Some chairs serve in a full-time capacity and others in a part-time capacity. Those that serve part-time tend to view themselves as the leader of the governance process and as a mentor and adviser to the CEO. Those that serve full-time believe the chairman of the board needs to be powerful, needs access to all information, and must be in constant dialogue with management and with other board leaders. Whether a part-time or full-time chair is



better depends on the various dimensions of board structure and process and on how people work together in any given FI's individual case.

### *Board committees*

Various regulatory and stock exchange rules and regulations speak to the committees FIs should maintain. In addition, certain commonalities are evident:

- ◆ Almost every FI now has a separate risk committee, and many did prior to 2008. Its role is crucial, as is the manner in which it engages with management, especially the CRO, the CEO, and the heads of lines of business. (For more detail, please see Chapter 3: Risk Governance: A Distinctive and Crucial Element of FI Governance.)
- ◆ The audit committee plays a substantial role, even after divesting itself of some risk responsibilities.
- ◆ The compensation or human resources (HR) committee has an increasingly high profile.
- ◆ The nominating and governance committee plays a critical role in the oversight and continuous improvement of board governance, and also in shaping, with the chair, a vibrant board composed of complementary, collaborative, and committed directors.
- ◆ Some FIs have strategy committees and a variety of other committees, as well.
- ◆ While much of the work of the board gets done in committees, all of the important decisions are taken by the board.

The exact complement of committees will vary by FI, but it is important not to have too many, because that can diffuse the responsibility of the board, particularly if the committees' actions are not well coordinated.

Committee chairs play an important role: they must set the committee's agenda, act as the primary interface with management, lead the committee to a deep understanding of the business issues and choices before it, communicate the committee's messages and recommendations to the chairman and then to the full board, and follow up.

### **Board size**

Among the FIs interviewed for this initiative, board size ranged from a minimum of eight members to a maximum of 23. The average board size was just over 14, and the most frequent number on the board was 16. Where executive directors are permitted by law, it is advisable to keep their numbers to a bare minimum relative to non-executive directors.

There may be legal or pragmatic reasons for larger boards, or larger boards may simply be preferred. A larger board may be necessary in the following cases:

- ◆ When important multiple shareholder interests require representation
- ◆ When there are executive board members who are essential to effective function
- ◆ When geographic scope makes foreign nationals an important board asset
- ◆ To imbue the board with gender and ethnic diversity, which can be considered vital.

However, the bigger a board gets, the more difficult it is to manage. Meetings can get out of control or become so structured that it is difficult to have effective debate. Ultimately, the right size of the board depends on those seated around the table and how they interact, but on balance, smaller boards that require a greater time commitment from their members are better than larger boards that require a more modest commitment.



A board of 10 to 12 members can operate efficiently, cohesively, and decisively. It is also easier to get input from everyone if the board is smaller, and smaller boards tend to be a more intimate and comfortable with candor. On larger boards, bad news tends to stay just below the surface. Making just this point, one chairman observed, “*The bigger the crowd, the better the news.*”

Some board chairs point to the need to populate as many as six or seven committees as a reason to expand the board, but perhaps most would agree, upon reflection, that letting committee structure dictate the number of board members is not advisable.

## **2. RECRUIT MEMBERS WHO COLLECTIVELY BRING A BALANCE OF EXPERTISE, SKILLS, EXPERIENCE, AND PERSPECTIVES AND WHO EXHIBIT IRREPROACHABLE INDEPENDENCE OF THOUGHT AND ACTION.**

FIs need balanced boards that include individuals with diverse experience and perspective. FI expertise will be an asset, but other experience is also both valuable and necessary. CEOs tend to make excellent board members, as do former senior regulators and supervisors. Independence of mind is essential, as are judgment and maturity.

### **Diversity and expertise**

In the wake of the crisis, FIs have been pressured to increase the number of board members with significant financial experience. While FI perspectives from the board can be helpful as a counterpoint to executive views, the board’s function is not to out-debate the executive on technical issues. Although board and risk committee chairs can generally benefit from prior FI experience, in some cases a board

or risk chair with outstanding leadership skills, credibility, and independence will be a superior choice to a former FI executive.

Indeed, in some countries and in some FIs, the board may have become overweighted with FI expertise. Too many FI veterans can lead to groupthink. In addition, too many FI veterans on the board or on specific committees, such as the risk committee, can overwhelm those without extensive FI experience. Furthermore, it has become very difficult to recruit outstanding individuals with FI experience, and in some jurisdictions this has become an overwhelming constraint.

But board members with other sorts of experience can also benefit the board. Members with vitally important geographic and customer segment expertise, for example, can lend critical advice and insight. They represent the perspectives of clients and customers and understand the dynamics of those markets. Others bring great functional experience—information technology provides an obvious example. Diversity extends as well to gender and ethnic considerations, not as a concession to political correctness, but because an indispensable characteristic of an effective board is its openness to different ideas, ways of thinking, and points of view.

### **Current or recently retired CEOs**

Current or recently retired CEOs may bring an invaluable perspective and the ability to challenge with credibility.<sup>8</sup> While more board members today are willing to stand up to a strong-willed CEO, former or current CEOs have executive experience that gives their criticisms more weight. Unfortunately, a committee chairmanship may demand more time than a sitting CEO can make available. Nevertheless, if a willing candidate can be found, including current CEOs on the board makes sense.

<sup>8</sup> To be clear, we are advocating the general skills of an experienced CEO, not suggesting that the former CEO of the FI should become a member of its board upon retirement.

### Former senior supervisors and regulators

FI boards and regulators/supervisors play complementary roles in governance, combining to exercise prudent restraint and add wisdom to key decisions. With due recognition of the latent dangers of “revolving door” placements of former regulators and supervisors into firms they once oversaw, the perspectives of those who have held senior positions in government can be extraordinarily helpful to effective board governance.

### Independence of mind

Independence is an indispensable trait in board members: independent board members can resist the pressure to be accommodating and thereby exercise uncompromising oversight. With only rare exceptions, directors must be economically independent and not reliant on the income they receive for their service on the board. Independence needs to be tempered by a common, shared agenda and a shared perspective on what the organization is trying to achieve.

### Judgment and maturity

Board members need the skill and experience to know how to intervene effectively in a given situation while not attempting to overstep bounds. They must know how to challenge without undermining respect, and they must be able to recognize when matters need further discussion and investigation.

### Building the board

It has become increasingly difficult to assemble the skills and personalities necessary for an effective board, and it is likely to become even more difficult. Talented FI executives without competitive conflicts are scarce. Fewer and fewer CEOs are willing to allocate the time and accept the legal accountability board membership entails. The candidate pool often includes many people who have not been CEOs,

who are no longer in the business, or who have not been involved in global businesses. Their ability to contribute, based on other experiences and expertise, tends to be more targeted.

The intangible element of chemistry plays a huge role in a board’s effectiveness. The personalities involved are key, so that element, too, must be considered.

The suitability of each potential new member must be assessed against the board’s current composition, the plan for adding or strengthening key dimensions of the board, and with adequate attention to the pool of candidates available and the delicate but distinct trade-offs among them. This is an ongoing process of review and renewal. The role of the nominating and/or governance committee is crucial in this process. The decision requires balanced judgment.

## 3. BUILD, OVER TIME, A NUANCED AND BROAD UNDERSTANDING OF ALL MATTERS CONCERNING THE STRATEGY, RISK APPETITE, AND CONDUCT OF THE FIRM, AND AN UNDERSTANDING OF THE RISKS IT FACES AND ITS RESILIENCY.

FI board members must gain the understanding they need to make good choices and decisions. They must understand the financial industry, the competitive and regulatory landscape, the firm’s own balance sheet and risk profile, and the leadership team. How does a board arrive at that understanding, and how much understanding is enough?

Not so many years ago, boards tended to be composed of a mix of executive and non-executive directors, with executives occupying half or even more of the board seats. Executive members brought detailed knowledge, and non-executive members brought external experience. In recent years, the global trend has been away from executive members on the board, the thinking being that non-executive

members are better able and more likely to challenge management proposals, while executives can always be called upon to provide expertise as needed without being given a directorship.

With regard to non-executive directors, it bears remembering that FI experience alone is not enough to ensure that non-executive directors understand all that they need to know on the board. They may have come from firms that are quite different from the institution in question; furthermore, FI industry understanding becomes outdated rather quickly.

The board must understand not only the issues and choices FIs face, but also the quality and capabilities of the leadership team. The board needs to meet the management team—at dinners, in meetings, informally—so it can be sure the members of the team are capable of executing their jobs. What are their weaknesses? Is there a sufficient pool of successors for key management roles—not only the CEO, but other key positions as well—to draw on when the need arises? Interacting regularly, but not intensively, with management can yield meaningful insight.

Understanding comes from three primary sources: initial education and ongoing training, engagement with management, and engagement with external constituencies.

### **Initial education and ongoing training**

New board members, even those with significant boardroom experience, need a thorough program of initial education in order to be effective. This critical period of learning should last at least a year and perhaps longer.

Board members should learn the history of the institution—not simply the last few years, but back 25 or even 40 years. They should also be thoroughly familiar with the position of the FI today and its aspirations for the future. Familiarity with the findings and conclusions of the most highly regarded equity analysts is essential and is an effective way to gain an external perspective on issues.

Getting up to speed is a challenge; staying abreast of developments in this fast-moving sector requires continual effort. Great boards invest substantial time and effort in ongoing training, outside of board and committee meeting time, focused on new and newly relevant issues. These might include regulatory developments and their implications, emerging risks, and regular deep tutorials on key issues in the environment or within the firm.

### **Board engagement with management**

FI boards are more deeply engaged with the details of the business than they were five to 10 years ago, and they depend on management for the vast majority of the information they receive. Management must provide the right information, with the right level of detail, and with as little bias as possible.

The nature and level of board members' engagement with management and the amount of time they commit to their board duties varies greatly. In some cases, the board is so active that the only question is whether it is going too far. The board must respect that management runs the company on a day-to-day basis and management therefore bears responsibility for the firm's outcomes.

For some boards, an intimate relationship with management works best, while for others, maintaining a certain distance, keeping the onus on management to surface issues and provide information, has proven to be the best approach. Irrespective of style, an effective board must engage as deeply as needed to understand how the business is running, how risk appetite is working in practice, and how management is performing.

### **Board engagement with external constituencies**

Board members should be encouraged to engage with external constituencies—supervisors and shareholders.

Supervisors are actively seeking a deeper and more nuanced understanding of how the board works, how key decisions are reached, and other factors relevant to effective governance, and directors can respond by engaging in more unscripted, interactive discussions with supervisors, held on a more routine basis. Over time, a director can impart substantial understanding of how the governance system is working and the key issues being addressed. In return, directors gain an understanding of the supervisor's perspectives and concerns, unfiltered by management. Directors should closely coordinate with management regarding these interactions and interactions with other external constituents, however. (For more detail on board engagement with supervisors, please see Chapter 5: The Role and Responsibility of Supervisors.)

Engagement with shareholders must be, of necessity, more selective, but the benefit of that engagement is a deeper understanding of shareholders' views and the opportunity to share the board's thinking on matters of concern. (For more detail on board member engagement with shareholders, please see Chapter 6: Relationships between FI Boards and Long-term Shareholders.)

#### **4. APPOINT THE CEO AND GAUGE TOP TALENT IN THE FIRM, ASSURING THAT THE CEO AND TOP TEAM POSSESS THE SKILLS, VALUES, ATTITUDES, AND ENERGY ESSENTIAL TO SUCCESS.**

A fundamental role of the board is the appointment of the CEO. Even the best strategy may prove useless absent a talented leadership team, headed by a CEO who is capable of executing it. Generally, the board plays the pivotal role of hiring and firing the CEO, although in some jurisdictions regulatory authorities vet candidates and approve the final selection, attesting to the chosen candidate's "fit and proper" credentials.

#### **Choosing the CEO**

Succession planning for the CEO is of critical importance. In many cases, an internal candidate offers powerful advantages over a candidate from outside the firm. Internal candidates are more familiar with the FI, its strategy, its strengths and weaknesses, and its people, and the board is more familiar with an internal candidate's character, capabilities, weaknesses, internal reputation and respect, and fit with the challenges facing the institution. In other cases, particularly where a break from the past is required, an external candidate will be the superior choice. A candidate field that includes both internal and external candidates typically yields the greatest confidence in the ultimate choice.

Given a choice between a very good CEO and a "star" CEO, the former is preferable to the latter. Very good CEOs tend to get the job done reliably, without undue fanfare. They share credit and build support internally and externally. They listen well and balance decisions carefully. They care much more about doing the right thing than about being right. Star CEOs, by contrast, may conflate the FI's success with their personal goals. They may advance their own ideas in preference to listening to the good ideas of others, and they may start to believe their own press. They can come into tension with board members, including the chair. A CEO should avoid star-like behaviors in the interest of the FI.

An essential determining factor of effective governance is the CEO's attitude toward the board. The CEO must respect the board's role and prerogatives and must accommodate and even encourage the board's challenges and questions.

For its part, the board must monitor the CEO to assure his or her continued suitability. CEOs change over time—many for the better, but some for the worse. Their views on the business may become rigid, and they are susceptible to hubris. Their implicit priorities can subtly shift from the FI to their own legacy. Boards must not blindly assume that the

CEO remains fit and proper; they must not permit a sense of loyalty to interfere with a dispassionate assessment of performance. Boards must always be cultivating successors. CEOs without a viable set of successor candidates and a strong executive team are particularly vulnerable to “imperial” attitudes and behavior.

### Gauging senior leadership

In addition to hiring and firing the CEO, the board of directors should be consulted on senior-level appointments. Building the top team is certainly a core CEO responsibility, and an effective board should be wary of meddling, but a wise CEO will seek counsel. At a minimum, the board must confirm the appointments of corporate officers for whom independence from line of business management is critical. These typically include the internal auditor, the chief financial officer, the chief risk officer, the chief compliance officer, and the chief legal officer.

While some senior appointments are planned and others are unplanned, the CEO and the board must be prepared for all of them, which means that FIs must have robust talent tracking and development programs in place. The best of these systems not only assess individual performance and capability compared with peers inside the firm, they include external benchmarking. These systems let the board know where the FI has outstanding talent relative to competitors and where gaps may exist.

In addition, board members must be afforded many and diverse opportunities, over time, to gain direct, personal familiarity with key senior managers. Board members’ insights into the character and capability of the leadership team are vital to effective governance.

Many compensation or HR committees are by charter responsible for leadership development. One unfortunate consequence of the important, and public, issues related to pay structures, levels, and policies, however, is that some of the compensation

committee’s attention has been diverted away from matters of talent development. To the extent that this is true, committee chairs and full boards must pick up the slack, since talent is a critical prerequisite for the firm’s success and safety.

### Making compensation arrangements for the CEO and executive leaders

Alongside the board’s role in gauging top talent in the firm is its crucial responsibility to set the structure and levels of pay for the CEO and the top team, and to approve the design of pay arrangements deeper in the organization.

Careful structuring of incentives and compensation are essential to properly align the goals of the executive talent leading a firm with the strategy identified and championed by the board. Compensation practices appropriate for each firm are a significant factor in governance and must receive close attention by the board and the compensation committee. Failure to focus squarely on this matter can otherwise result in a misalignment that on occasion can imperil the health and reputation of the firm.

The subject of compensation has been amply studied elsewhere. The G30 commends the FSB Principles for Sound Compensation Practices and supports the full implementation of the 19 principles and the steps being taken by the Board to assure consistent application across different jurisdictions, while cognizant of differing cultural approaches.

## 5. TAKE A LONG-TERM VIEW ON STRATEGY AND PERFORMANCE, FOCUSING ON SUSTAINABLE SUCCESS.

Whose interests does the board represent? Philosophies, laws, and practices vary around the world. U.S. law and mindset puts shareholders first. Employees are expressly included in two-tier boards with codetermination features, while other jurisdictions legally require employee interests to be



considered alongside others'. In some jurisdictions, boards have responsibilities to depositors and creditors, as well. Given the unique externalities of FIs, society's interests and well-being must always be a high priority for the board.

Regardless of whom the primary stakeholder is, FI boards in every country ought to take a long-term view on strategy, similar to that of an owner for whom it would be impossible or inconvenient to sell. The board must have an inviolable commitment to the long-term success of the firm. The proper time frame is five to 10 years or more, because business models and technology take time to change or replace. Looking at the next two years is not strategic; it is tactical. Boards must oversee the present and ensure the future.

This long-term view encourages enduring value creation in the shareholders' interests. It elevates the value of prudence without diminishing the importance of innovation, and it reduces short-term self-interest as a motivator. It brings into the foreground the firm's dependence on its pool of talent and demands the firm play a positive role in society. Taking a long-term view, all interests—with the exception of those of a few short-term share-owners—tend to converge.

## **6. RESPECT THE DISTINCTION BETWEEN THE BOARD'S RESPONSIBILITIES FOR DIRECTION SETTING, OVERSIGHT, AND CONTROL, AND MANAGEMENT'S RESPONSIBILITIES TO RUN THE BUSINESS.**

Boards need to both increase their governance role and also strike the appropriate balance that permits management to execute agreed FI strategies and run the firm. The board must limit itself to providing guidance; it cannot run the FI. Management runs the FI, but boards provide an important check and balance.

The responsibilities of the board and management are distinct but should be complimentary. The board's primary responsibilities vis-à-vis the management of the firm are: (1) reaching agreement with management on a strategy, including the firm's risk appetite and its contours; (2) choosing a CEO capable of executing the strategy; (3) ensuring a high-quality leadership team is in place; (4) assuring appropriate processes, people, and resources are dedicated to compliance with all applicable regulatory, legal, and ethical rules and guidelines and ensuring that appropriate and necessary risk control processes are in place; (5) ensuring all stakeholder interests are appropriately represented and considered (including issues of remuneration); and (6) providing advice and support to management based on experience, expertise, and relationships.

The pressures of an adverse environment drive increasing levels of engagement and draw boards closer and closer to the operations of the firm. In such an environment, it is hard to keep governance separate from management. It can be especially hard for board members to resist the temptation to cross the line into management because so often they themselves have been or still are managers. However, it is essential that the board remain independent and allow management to execute the day-to-day activities of the organization.

Regulators and supervisors are demanding the board sign off on more and more management processes. By signing off, the board attests to an implied understanding of subjects when in fact board members' understanding may be no more than cursory. A sign-off should be understood as meaning that the board has questioned management intensively and is now comfortable that the processes in question have integrity and that management has performed the necessary work properly. The board itself makes few decisions compared to management. It has a limited view into the details of operations. It cannot vouch for detailed compliance; it can only assure supervisors and shareholders that it has done its best

to obtain reasonable assurance and satisfy itself on the integrity of control processes.

In some cultures, the fundamental division of responsibilities between the board and management can be summarized in easy-to-understand terms: management runs the FI, and the board controls management. It is a simple formulation that makes the important distinction that boards do not manage, they govern. However, there is much more subtlety to the board-management relationship, which will be explored in a subsequent chapter.

## **7. REACH AGREEMENT WITH MANAGEMENT ON A STRATEGY AND CHAMPION MANAGEMENT ONCE DECISIONS HAVE BEEN MADE.**

Contrary to popular conception, the board rarely takes the lead in devising the strategy of the FI. In most cases, management proposes strategy, the board challenges and discusses the proposal, revisions are made, details are discussed, and—finally—the board and the management team arrive at a strategy to which all are fully committed. The board may challenge management if it feels management has been overenthusiastic or if the board thinks management is shooting too low or too high. It is ultimately the board's prerogative and responsibility to make the decision on strategy, as it is with capital, leverage, risk, and selecting the CEO.

The strategy must include a well-articulated, actionable statement of risk appetite. If the risk appetite is framed clearly, management has the parameters it needs to make day-to-day risk decisions, and apart from the board's role in shaping the risk appetite and approving certain risk policies and strategies, management makes virtually all decisions on risk. (Risk appetite frameworks are discussed in more detail in Chapter 3: Risk Governance: A Distinctive and Crucial Element of FI Governance.)

There must be respect on both sides of the board-management equation. Management must respect

the board's role and its challenges. It must do its utmost to inform the board of issues so that the board can exercise good business judgment. It must supply whatever information and analysis the board feels is needed. It must devise alternatives for consideration. And, it must accept the ultimate decision of the board on matters of strategic importance. For its part, the board should champion management as management executes the agreed plan. The CEO must be fully empowered to execute the plan. The board must support management in strategy execution, even when the inevitable problems and unanticipated challenges emerge.

## **8. CHALLENGE MANAGEMENT, VIGOROUSLY AND THOUGHTFULLY DISCUSSING ALL STRATEGIC PROPOSALS, KEY RISK POLICIES, AND MAJOR OPERATIONAL ISSUES.**

*“A functioning board is one where people feel they are free to speak and never get the sense that they are being pushed to the side ... Directors should feel able to ask any questions they want, to upset the agenda, to get direct answers ... Directors are entitled to an answer.” —FI CHAIRMAN*

The exercise of its role as a check on management requires that the board challenge management's proposals and perspectives. Strategic choices and risk policies always command a high priority for board discussion and debate and claim a regular place on the board's agenda.

Challenging management is more than mere naysaying. Challenge involves mutual learning and progress toward agreement—on an idea, an issue, a proposal, or a decision. Board members seek information so that they can understand options, alternatives, implications, and consequences. They ask probing questions. These surface new considerations. They may seek third-party expertise, hold discussions in executive session, and schedule meetings with executives “offline.” On any important



decision, the board and management typically have several opportunities for discussion and debate. At the end, a proposal emerges that everyone accepts, and the board then supports the decision and the management teams are tasked with execution. Although this process may never have garnered a no vote, it nonetheless involved challenge.

Effective challenge demands integrity from both the board and management. One chairman described the “*perfect question*” game: If a director could ask the perfect question of a manager, the director would get the perfect answer—that is, one that contained the real insight sought. Otherwise, the director would simply get a direct answer to the question asked, with little insight. In a functional relationship, the management leader might reply, “*I think what you are driving at with your question is... That is a troubling issue that we have debated a great deal and not yet resolved. Here is how we have thought about it...*”

Boards must be careful not to undermine their own processes. There are occasions when challenges have been disingenuous or even driven by ulterior motives. Board members who challenge just to have their challenge recorded in the minutes are not acting in the interest of the institution, but merely in their own defense.

## **9. ENSURE THAT RIGOROUS AND ROBUST PROCESSES ARE IN PLACE TO MONITOR ORGANIZATIONAL COMPLIANCE WITH THE AGREED STRATEGY AND RISK APPETITE AND WITH ALL APPLICABLE LAWS AND REGULATIONS. PROACTIVELY FOLLOW UP ON POTENTIAL WEAKNESSES OR ISSUES.**

Oversight and compliance involve not only the audit function, but also risk governance and control. The board must ensure that management decisions and

actions remain consistent with the chosen strategy. It can be expected to ensure that policies and procedures are in place to monitor compliance, but it cannot vouch for compliance. Nor should boards be required to set risk limits or approve all risk policies, which might number in the thousands. These are tasks for management.

Compliance and audit responsibilities represent a major role of the board in governance. Many directors are rightly concerned that compliance and oversight functions, many required by law, have begun to seriously crowd out other critical board agenda items. A board agenda may include as many as 50 legally mandated compliance items, administrative in nature. But boards may make a critical mistake if they permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk governance, and talent issues.

Corporate secretaries, with support of the board chair, need to continue to find ways of accommodating these legal requirements with optimal efficiency. Regulators and supervisors need to carefully consider whether further burdening the board agenda is wise, especially as they are apt to get limited value in return. Governance cannot be permitted to become a compliance exercise.

## **10. ASSESS THE BOARD’S OWN EFFECTIVENESS REGULARLY, OCCASIONALLY WITH THE ASSISTANCE OF EXTERNAL ADVISERS, AND SHARE THIS ASSESSMENT WITH THE LEAD SUPERVISOR.**

In most jurisdictions, boards are required or strongly encouraged by regulators and stock exchanges to conduct their own performance assessments. The following approaches to assessment are common:

- ◆ Board chairs ask for direct feedback regarding their performance as chair, signed or anonymous,

and for suggestions for improvement in process, practice, and leadership.

- ◆ Board members provide assessment and feedback to one another anonymously. This constructive feedback is shared and discussed.
- ◆ Committees of the board assess their performance, often under the purview of the governance committee.
- ◆ An outside board evaluator is employed. Evaluators' approaches differ: Some are quite psychologically inclined and get deeply into behaviors, while others are more process oriented. All make use of extensive interviews.

Typically, the insights are reviewed and worked through with the board chair and other key board leaders, such as the governance committee chair, the lead director, the vice-chair, and so forth, and then they are reviewed thoroughly with board members. The board then develops a plan for driving improvements.

Most changes happen gradually, over two or three years. Maintaining the same approach and the same external adviser permits longitudinal tracking. On the other hand, using the same approach year after year can rapidly become stale: after several years, it may be hard to garner fresh insight. For this reason, many boards change approaches from time to time.

The board should pay great heed to these assessments and be willing to discuss them with the lead supervisor. Supervisors have a legitimate interest in governance effectiveness and try to make their own judgments. Those judgments will be better if they have access to the board's assessment. Admittedly, this recommendation is not without potential downsides. If the board assessment is sugar-coated or

even just biased by the fear that the supervisor might unduly criticize, much of its value can be lost. However, in an environment of mutual respect and trust, the benefit of success will exceed the risk of failure.

To nurture trust, supervisors need to accept that it is a sign of effective governance (and not something to be highlighted in a supervisory letter as a problem) for there to be issues that have been identified and are being addressed by management and/or the board.

\* \* \*

The essential tasks outlined above are articulated from the perspective of a unitary board. A two-tier board addresses essentially the same governance tasks, though how this is accomplished depends on the extent to which the supervisory board is constitutionally or in practice capable of engaging in core issues such as the determination of risk appetite and strategy.

The more the supervisory board is confined to a role of monitoring and audit, the greater the reliance on the executive board for governance. This places huge responsibility at the feet of the executive board, which must discharge its duties without the benefit of the challenge, guidance, and support that is extended to the executive by the chairman and non-executive directors in a well-functioning unitary board. In practice, however, and notwithstanding the continuing formal separation of the supervisory board from the executive board in Germany, Switzerland, and the Netherlands, a process of evolution, in particular since the financial crisis of 2008–2009, has led to much closer engagement of many FI supervisory boards in matters of risk appetite and strategy.



## CHAPTER 3

# *Risk Governance: A Distinctive and Crucial Element of FI Governance*

*Those accountable for key risk policies in FIs, on the board and within management, must be sufficiently empowered to put the brakes on the firm's risk taking, but they also must enable the firm to conduct well-managed, profitable risk-taking activities that support the firm's long-term sustainable success.*

Financial risk of some form, or a means of hedging it, is a key ingredient of every service or product offered by an FI, a characteristic that distinguishes FIs from other types of business. While other companies bear financial risk alongside and in complement to their core business activity in, for example, health care, energy exploration, or manufacturing, the assumption and management of financial risk is unavoidably integral to the core business of an FI. One chairman simply stated, “*The essence of FI governance is understanding risk.*”

The history of financial crises, including the 2008–2009 crisis, is littered with banks and other FIs that collapsed or were taken to the brink by a failure of financial risk governance. The most recent financial crisis demonstrated the inability of many FIs to accurately understand, gauge, and manage their risks. Firms greatly understated their inherent risks, particularly correlations across their businesses, and were woefully unprepared for the exogenous risks that unfolded during the crisis and afterward.

Since the crisis, many welcome improvements in risk measurement, risk management, and oversight have been made. These improvements have been driven by a combination of regulatory pressure and self-evaluation. Initially, many firms increased board engagement in risk and improved the link to strategy. In addition, most firms improved the quality of their risk leadership by establishing

separate risk committees and appointing higher-quality, empowered chief risk officers (CROs). These new risk leaders have improved their firms' risk infrastructure.

However, few large FIs would claim to have completed their risk journey; indeed, those that understand the scale of the challenge know the journey never ends. Improvements are always the order of day, given the ever changing economic, political, and market environment. Risk managers must remain vigilant to the particular challenges posed by the risks associated with new products, processes, and markets. Risk governance must adapt ahead of, or at least abreast of, change.

Effective risk governance within FIs requires several actions on the part of boards and management teams.

## **PROVIDE INDEPENDENT, COMPETENT RISK LEADERSHIP**

1. Establish a board-level risk committee that supports the board's role in approving the firm's risk appetite and that oversees the risk professionals and infrastructure.
2. Ensure the presence of a CRO who is independent, has stature within the management structure and unfettered access to the board risk committee, and has the authority to find the appropriate balance between constraint and support of risk taking.

## **MAINTAIN ROBUST RISK FRAMEWORKS, INFRASTRUCTURE, AND INFORMATION SYSTEMS**

3. Determine a risk appetite that is clearly articulated, properly linked to the firm's strategy, embedded across the firm, and which enables risk taking.
4. Actively assess and manage the risk culture so that it supports the firm's risk appetite.
5. Ensure directors have access to the right level of risk information so as to see and fully comprehend the major risks.
6. Maintain robust risk information technology (IT) systems that can generate timely, comprehensive, cross-geography, cross-product information on exposures.

## **FOCUS CONTINUALLY ON RISK AWARENESS AND FIRM AGILITY**

7. Maintain an ongoing focus on emerging risks by having a holistic, vigilant view of all major risks, strategic and product creep, excess complexity, and areas of overperformance.
8. Strengthen the firm's ability to withstand exogenous shocks, recognizing that it is impossible to avoid financial stresses when they come.

These actions are discussed in detail in the pages that follow.

## **1. ESTABLISH A BOARD-LEVEL RISK COMMITTEE THAT SUPPORTS THE BOARD'S ROLE IN APPROVING THE FIRM'S RISK APPETITE AND THAT OVERSEES THE RISK PROFESSIONALS AND INFRASTRUCTURE**

Major FI boards should establish a separate risk committee of the board, if they have not already done so.<sup>9</sup> Risk committees play a very important part in the FI control network by improving the focus and dialogue on risk. The risk committee's core mission should be to shape, and then present to the full board for approval, the firm's risk appetite within the context of the firm's chosen strategy. It should ensure the risk culture supports the desired risk profile and that risk leaders and professionals are capable, empowered, and independent. It should also ensure that the firm has the necessary risk infrastructure in place. Risk committees should provide advice, oversight, and challenge, digging deeper and cross-examining management as necessary. They should play an active role in driving the firm's risk agenda.

Risk committees need a mix of skills. Some committee members should have relevant financial-service-sector experience or technical risk expertise, so that they have sufficient understanding of the underlying concepts when approving risk appetite frameworks and risk limits. However, as on the full board, there is great value in having generalists from outside the industry on the risk committee. They often ask basic questions that unearth real issues or,

<sup>9</sup> Only a few large FIs have chosen not to establish a separate risk committee, and many are now required to do so. In our survey of large FIs, the average size of the risk committee was five members, with a range of three to 11. The 11-member risk committee comprises all of the non-executive directors.

at a minimum, force executives to be more articulate in explaining the firm's risks and risk approach. They prevent the type of groupthink that can occur if the committee is staffed entirely by directors from within the industry or with technical risk experts. Regardless of their underlying skills and experiences, all committee members should dedicate sufficient time to their risk responsibilities.<sup>10</sup>

## **2. ENSURE THE PRESENCE OF A CRO WHO IS INDEPENDENT, HAS STATURE WITHIN THE MANAGEMENT STRUCTURE AND UNFETTERED ACCESS TO THE BOARD RISK COMMITTEE, AND HAS THE AUTHORITY TO FIND THE APPROPRIATE BALANCE BETWEEN CONSTRAINT AND SUPPORT OF RISK TAKING.**

As stated in Chapter 2, boards should approve the appointment and dismissal of the CRO. The CRO's compensation should be recommended by the CEO and reviewed and approved by the risk committee, in consultation with the board's compensation committee. In some of the major FIs that failed or suffered badly in the crisis, the CRO and risk professionals struggled to properly influence their firm's risk-taking activities. They lacked sufficient independence from and credibility with the firm's top management and business units. That situation can be avoided by ensuring the CRO has the independence, skills, and stature to influence the firm's risk-taking activities, directly and through the risk professionals who the CRO oversees.

The delicate balancing act between independence and collaboration in the board's relationship with management is especially evident in the operation of the risk function. FIs differ on whether the CRO should have absolute veto power. Some firms give

the risk professionals the last word on risk. Under that approach, the CEO must accept the risk function's view. Others take a more nuanced position and permit the CEO to support the business, notwithstanding the CRO's concerns. In all cases, open dialogue with senior management ensures that everyone understands how risk decisions are being made and that consideration is given to any CRO concerns. The CRO should play a key role in major risk decisions. The CRO and the risk team at large should also maintain a good working relationship with the business units, so that the overall feeling is one of collaboration rather than antagonism. The risk function should be seen as facilitating decision making and not strictly as a compliance function.

CROs need the following characteristics and conditions to be successful:

- ◆ They need business acumen so they can balance risk mitigation and business exigencies and command the respect of the board, management, and employees at large.
- ◆ They must be good communicators, because they need to be able to tell a compelling narrative to people who are often less qualified in technical risk matters.
- ◆ They need courage and conviction, and they should be willing to walk away from their job if their judgment on major issues is ignored.
- ◆ They should have the right stature in the organization.
- ◆ They should be a member of the senior management team and should report to the CEO.
- ◆ They should have high visibility in the boardroom and should have unfettered access to the chairman of the risk committee and the full board when necessary.

<sup>10</sup> Risk committees have generally increased the hours they devote to their oversight responsibilities, holding as many as 10, 12, or even 14 meetings per year, with meetings lasting as long as six hours. According to our survey data, most risk committee chairs are spending between 20 percent and 50 percent of their time on their duties as directors.



### **3. DETERMINE A RISK APPETITE THAT IS CLEARLY ARTICULATED, PROPERLY LINKED TO THE FIRM'S STRATEGY, EMBEDDED ACROSS THE FIRM, AND WHICH ENABLES RISK TAKING.**

The board needs a full understanding of the firm's strategy and risk appetite. The chosen risk appetite framework should frame the choices regarding risks in terms of the type of institution the board and management are trying to build and sustain, and it should clearly link risks and returns. This framework needs to be matched by a capacity to measure, understand, and manage that risk.

To be fully effective, the risk appetite framework must be embedded deep within the firm and linked to key management processes, such as capital allocation decisions, new product and businesses approvals, and compensation arrangements. Business plans and goals need to be written within the risk appetite framework. The framework's key parameters should be reflected in the firm's early-warning system, so that corrective action can be taken to avoid stepping outside of the firm's chosen risk tolerances. Risk statements should be converted into measurable actions that can be easily communicated to the front line and used as a means to reinforce the institution's strategy throughout the firm.

Resilience to unforeseen events must be considered alongside risk appetite. Resilience is linked to capital and liquidity buffers, stress testing, living wills, and related matters.

There is a danger that complying with the risk appetite framework can become too much of a technical exercise. While a framework provides some ground rules for what can and cannot be done, its real power comes from enabling a candid risk dialogue between management and the board. A risk appetite framework establishes clear parameters within which strategic decisions can be made. A risk appetite statement, properly used, should enable decision making, not stall risk taking. In avoiding excessive

risks, firms must not go too far in the other direction: if they become too risk-averse, they may forgo profitable business opportunities that would not create undue risk.

### **4. ACTIVELY ASSESS AND MANAGE THE RISK CULTURE SO THAT IT SUPPORTS THE FIRM'S RISK APPETITE.**

Ultimately, no risk appetite statement, limit structure, or risk management system can accommodate every situation: the institution must depend on its risk culture. The risk committee and full board play a critical role, with management, in ensuring that the risk culture is consistent with the firm's risk profile aspirations. Often, however, boards and management teams struggle to measure culture—its current status and direction—and feel handicapped on how to best influence it.

In practice, firms that actively manage their risk culture focus attention on individuals' behaviors. Culture can be viewed as a high-level aggregation of those behaviors. Directors and executives should draw on intelligence gathered across the firm in employee surveys, internal audit reports, risk-limit breaches, and so on to evaluate these behaviors. Each piece of information contributes to a portrait of the firm's culture and the direction in which the culture is moving. Directors and executives can then address those traits and trends that do not reflect the culture they want to encourage, while supporting those they do.

The tone set at the top of an FI is also important. Non-executive directors are well placed to monitor and evaluate tone at the top, given their significant exposure to senior management. However, they also need to be attuned to the culture deep in the organization and how the messages at the top are communicated and interpreted by employees. As such, non-executive directors should seek out the views of supervisors and the external auditor, who spend more time within the organization on a day-to-day basis.

## **5. ENSURE DIRECTORS HAVE ACCESS TO THE RIGHT LEVEL OF RISK INFORMATION SO AS TO SEE AND FULLY COMPREHEND THE MAJOR RISKS.**

Boards need sufficient information to effectively oversee the firm's risks and controls and to make judgments, including the judgment that they do not understand enough about a major risk to approve it. Such information should include appropriate summaries of macroprudential assessments published by central banks and other regulatory bodies and, where available, high-quality sell-side or debt-rating agency research, all of which provide a valuable external perspective for the risk committee.

Risk committees and boards need information—especially on key risks—in a digestible format. The aim is simple but comprehensive communications. Risk reporting should highlight key long-term trends, provide transparent assumptions, and have a decision orientation. The resulting reports should be broadly distributed among board members—ideally to all board members—so that risk knowledge is not confined to the risk committee.

## **6. MAINTAIN ROBUST RISK INFORMATION TECHNOLOGY (IT) SYSTEMS THAT CAN GENERATE TIMELY, COMPREHENSIVE, CROSS-GEOGRAPHY, CROSS-PRODUCT INFORMATION ON EXPOSURES.**

Ultimately, the quality of risk information that FI boards and management teams receive depends largely on the quality of the organization's IT systems. Ideally, FIs need risk IT systems that can gather risk information quickly and comprehensively, producing global, cross-product, cross-legal entity estimates of their exposures promptly. Unfortunately, few global FIs are capable of this. They are hampered by legacy systems that are inefficient, costly, and burdensome.

Boards are well advised to press management to maintain—and where necessary increase—investment in risk IT systems, both as a short-term priority and as part of a long-term strategic initiative.

Risk IT investments must not be sidelined by necessary upgrades to finance and customer data systems. Instead, they must be integrated and prioritized. Given that for many large firms, necessary investments will run to several billion dollars over the coming years, boards may need to rethink their approach to evaluating management's investment in core IT spending. While some firms still have the audit or risk committee review IT investments, others have established committees dedicated to IT oversight. That is an interesting trend, and worth further consideration.

## **7. MAINTAIN AN ONGOING FOCUS ON EMERGING RISKS BY HAVING A HOLISTIC, VIGILANT VIEW OF ALL MAJOR RISKS, STRATEGIC AND PRODUCT CREEP, EXCESS COMPLEXITY, AND AREAS OF OVERPERFORMANCE.**

FI boards and management teams must not lose sight of the core rationale for enhanced risk oversight and management: to spot and adapt to emerging risks, as early as possible. To that end, boards should take a broad perspective when overseeing risk. Too often, the focus is on financial risks, because they are measureable and easier to mitigate. However, operational and reputational risks are also very important. Operational problems can irreparably damage the franchise. Major reputational mistakes can take years to repair, and boards should be vigilant in protecting a hard-won reputation. Boards and management teams need to understand these various categories of risks and their interrelationship. They should be able to identify the major risks that can destroy the institution and ensure the firm is not exposed to them.

Boards must also guard against strategic and product creep, because sometimes it is the slow changes that create problems for FIs, not fast-paced shifts. Slow change in the FI's risk profile can, in the aggregate, be significant. Similarly, a new business entity might be set up for one purpose (for example, for tax) and then get used for other reasons, or a new product might be developed without its inherent risks being properly understood, or, once approved, it might be modified without a proper assessment of the consequent change in risk profile. And so on. Monitoring strategic and product creep requires diligence. Directors should ask questions about complex organizational structures—why they exist, what the operations do, what risks they present—and consider simplification. This also applies to businesses and products. And, in terms of remuneration, directors should also evaluate whether the FI's incentives unduly encourage strategic and product creep.

Overperformance should spark board-level inquiry. Management and boards often do not investigate overperformance—rather, the tendency is to applaud it—but it should be examined as critically as underperformance. In several cases in the financial crisis, it was the overperforming businesses that created risks well beyond what was expected, causing problems for the overall entity's financial stability.

## **8. STRENGTHEN THE FIRM'S ABILITY TO WITHSTAND EXOGENOUS SHOCKS, RECOGNIZING THAT IT IS IMPOSSIBLE TO AVOID FINANCIAL STRESSES WHEN THEY COME.**

An institution's ability to manage crises and withstand exogenous shocks is of paramount importance. No FI can position its balance sheet in advance to be resistant to all possible crises, but judicious advance planning and testing does increase institutional robustness, and for this reason, stress and scenario testing are valuable tools.

All large financial institutions use a variety of approaches, including forward-looking stress tests, scenario analysis, and the review of actual performance relative to risk estimates, that is, backtesting. Stress testing improves understanding and reveals areas that directors and executives should investigate more deeply. Stress tests also enable a real dialogue about meaningful economic scenarios, with a focus on what capital and liquidity cushions exist in those scenarios. Reverse stress testing, which tests the combination of factors that could cause the failure of the firm, can also be helpful.

However, stress testing can be overdone and become too hypothetical. Boards and management teams should also examine how their firms reacted to actual unanticipated events in the past, since those reactions can be very informative about the firm's resiliency. How did the firm deal with the event, how well was it prepared to withstand the consequent stresses, and what course corrections did it make? Backtesting the firm's risk profile and risk appetite can help to determine if the firm stayed within its risk limits by accident or by design, and if limits were breached, why that happened.

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Risk governance is essential to effective FI governance. Without an ability to properly measure, manage, price, and mitigate risk, FIs are destined to underperform or fail. Effective risk governance requires a dedicated set of risk leaders in the boardroom and executive suite, as well as robust and appropriate risk frameworks, systems, and processes.

Risk leaders must perform their roles with two competing objectives in mind. They have to be sufficiently empowered that they can put the brakes on the firm's risk taking and constrain its risk-taking capacity when necessary, but they also play a critical role in enabling the firm to conduct well-measured, profitable risk-taking activities that support the firm's long-term sustainable growth.

All of these considerations plainly apply equally in a two-tier board situation. While the long-standing formal structure in Germany, Switzerland, and the Netherlands separates the supervisory from the executive board, the substantive separation has narrowed appreciably in a process of evolution over the past decade. There has been particular focus on the increasing engagement of the supervisory board on matters of risk strategy since the crisis period of 2008–2009 which involved, in some importance instances, the introduction of the public sector as major shareholder.

While there are differences in practice, supervisory boards of FIs have increasingly formed board-level risk committees, and the clear trend has been toward enlargement of the role and responsibility of the CRO who, typically, attends supervisory board meetings and has direct access to the chairman. Put in other terms, major risk issues that are fundamental to the sustainability of a financial institution are, through a process of transition, increasingly addressed in two-tier board situations in substantially the same way as in unitary boards, notwithstanding the formal, constitutional differences between the two governance models.

## CHAPTER 4

# *Deep Commitment to Governance: A Requirement from Management*

*Management needs to play a continuous proactive role in the overall governance process, upward to the board and downward through the organization.*

Although in the final analysis, boards are ultimately responsible for the effective corporate governance of their institutions, good governance also includes a strong, functioning management team. Beneath management sits an array of control functions and business behaviors that directly influence how risks, both internal and external, are understood, measured, monitored, and controlled. Failure in any of these systems can be costly. In the extreme, it can put the firm in jeopardy. While the board and its committees oversee these controls, executives manage them on a day-to-day basis.

For management to play its governance role effectively, it must take the following actions.

### **VIGOROUSLY MANAGE THE CONTROL ARCHITECTURE.**

1. Be accountable for the daily effectiveness of the control architecture.
2. Ensure control professionals maintain a comprehensive view of the firm's risks, balancing prudence with encouragement of sustainable risk taking.

### **ASSIDUOUSLY CULTIVATE DIRECTOR UNDERSTANDING.**

3. Educate and inform directors on an ongoing basis.
4. Focus the governance dialogue on the key issues and bring the board early into management's thinking on key decisions.

5. Expose directors to a broad set of executives and employees, both informally and formally, so they get an unfiltered view of the company.

### **ACTIVELY SHAPE FIRM CULTURE.**

6. Work continually on modeling and supporting a culture that promotes long-term thinking, discipline, and accountability.
7. Encourage a culture of no surprises, the quick elevation of issues, toleration of mistakes, organizational learning, and punishment of malfeasance.
8. Build a trust-based environment that supports critical challenge and is open to change.

These actions are discussed in detail in the pages that follow.

### **1. BE ACCOUNTABLE FOR THE DAILY EFFECTIVENESS OF THE CONTROL ARCHITECTURE.**

Internal governance encompasses not only top management, but also a complex set of control structures below management that contribute to the firm's decision-making processes. These structures include risk, compliance, legal, and internal audit.

Management has responsibility for the effectiveness of these control functions on a day-to-day basis, and the board must hold management to account for control failures. Management must establish a control framework that, where possible, prevents problems, actively monitors the firm on an ongoing basis, and aggressively addresses issues that arise.

Further, management must ensure employees and executives adhere to company policy on routine decisions. Well-written policies that are ignored give a dangerous illusion of control. By the same token, even the most comprehensive policies cannot describe every situation, so judgment has to be applied to nonroutine matters. As such, the control framework should be able to elevate issues that fall outside the policy so that individuals do not navigate around policies without proper guidance and supervision.

## **2. ENSURE CONTROL PROFESSIONALS MAINTAIN A COMPREHENSIVE VIEW OF THE FIRM'S RISKS, BALANCING PRUDENCE WITH ENCOURAGEMENT OF SUSTAINABLE RISK TAKING.**

Strong controls require independent control professionals. Management has to ensure that those working in risk, compliance, audit, and so on are sufficiently independent to make observations on the control approach and, where necessary, influence the decision-making process. In some instances, they need veto rights.

However, the challenge control professionals face is similar to the challenge directors face, working with line of business management: they need to assert their independence and provide critical challenge, but they also need to be supportive, and not indifferent to the performance of the institution. They must be seen as supporting—even encouraging—sustainable, profitable risk taking, not as a police force. Encouraging controlled risk taking is as important as constraining dangerous risk taking.

Control professionals also need to be able to work together effectively. Large financial institutions often have tens of thousands of employees focused on control activities, and often they work too independently of one another. The worst case is a set of siloed groups working independently, not sharing insight, unnecessarily duplicating efforts,

and missing key risks or problems for lack of coordination. FIs must think holistically about their control architecture and ensure cooperation among the control professionals. This will aid in avoiding gaps in controls and oversight.

## **3. EDUCATE AND INFORM DIRECTORS ON AN ONGOING BASIS.**

The most important thing management can do to foster good governance is to give the board the best means of understanding company strategy, risk appetite, and the major challenges the company faces. Intelligent, on-target questions from board members are the best sign that management has given the board the right kinds of insights and information.

However, keeping the board informed is easier said than done. Boards are typically inundated with too much information, so the emphasis in communications to the board should be on clarity and synthesis. Communications should be understandable, decision oriented, and should promote open discussion between directors and management. Brevity is a challenge. Management must synthesize issues in a digestible fashion, but must avoid filtering out needed information. Metrics are important. They must be consistent and comprehensive and should enable holistic decision making.

Management should also expose the board to outside thinking, to give it direct access to other perspectives. In addition to gaining external perspectives from existing advisers such as the external auditor, or risk or other experts, board members should periodically hear from sources such as supervisors, large clients, sell-side or credit rating analysts, other expert industry observers, and prominent out-of-the-box thinkers.

Management must effectively orient new directors and educate existing directors on an ongoing basis. A robust training program will include ongoing deep dives into key businesses, risks, and



policy changes within the firm, external changes, or new regulations. These programs should be updated routinely. As mentioned in Chapter 1, directors should know the FI's history and its key economic, risk, capital, and product concepts so as to be better informed for present-day decision making. While all directors should be granted unfettered access to management, new directors especially should be encouraged to engage with management.

The board should have full access to any and all information it needs. The corporate secretary plays a central role in managing information flows and access to the board and therefore should have sufficient resources to fully serve the board's needs. Given their critical governance role, corporate secretaries must have an independent mindset and a firm commitment to honor their duties to the board and the company, and the board should be consulted on the corporate secretary's evaluation and compensation.

#### **4. FOCUS THE GOVERNANCE DIALOGUE ON THE KEY ISSUES AND BRING THE BOARD EARLY INTO MANAGEMENT'S THINKING ON KEY DECISIONS.**

Governance only works if management has a process for identifying the major issues and presenting them to the board for discussion. This requires executives to be proactive and organized in undertaking their governance roles. Board and committee topics have to be prioritized, and meetings must be well structured. Management must be attentive to potential new agenda items and keep an eye out for new educational opportunities (for the full board or personalized for a specific director), and it must consider other ways to facilitate effective communication between the board and management. Management must prepare well for meetings and ensure timely follow-up.

Management must discuss the major decisions with the board, sharing alternative perspectives. Executives must be comfortable with airing differences of opinion among the team in front of the board so that divergent views can be heard and discussed. As management hones its thinking on and analysis of issues, it must bring the board along, enabling healthy boardroom debate, as necessary. As noted earlier, board-management interaction on strategy setting is essential.

#### **5. EXPOSE DIRECTORS TO A BROAD SET OF EXECUTIVES AND EMPLOYEES, BOTH INFORMALLY AND FORMALLY, SO THEY GET AN UNFILTERED VIEW OF THE COMPANY.**

The financial crisis revealed that in some cases, the CEO had created a firewall between directors and key executives. Executives knew something was wrong, but they could not speak to the non-executive directors. If those firewalls had not been in place, alternative courses of action might have been taken or at least considered.

Nothing should hinder communication between directors and executives. Directors should be free to talk to the executives, and they should feel confident and comfortable in doing so. Without open communication, directors may have little idea of the true circumstances within the organization.

Management needs to be in front of the board regularly, and leading board members should be in continuous discussions with key managers. Some of the free-flowing interaction between board members and executives happens in the normal course of the governance process: the board chairman interacts with the CEO or his or her direct reports, the audit chair interacts with the finance team, the risk chair interacts with the CRO and risk team, and so on.

These interactions are part of the natural flow of board and committee meetings.

But management must create additional opportunities for interaction. The corporate secretary can arrange more targeted, nonroutine interaction in the form of meetings with the right employees or, alternatively, the director and executive may determine that the whole board or committee may benefit from knowing more about the specific topic, in which case the topic can be put on the appropriate agenda. By fostering informal interactions between directors and executives, the CEO plays a key role in enabling access, since informal interactions may be even more important than formal ones. These should include business and social components, which give directors an opportunity to get to know the executives better.

While interaction with management is important and necessary, directors should exercise it with care. Non-executive directors cannot just insert themselves into the organization at will. They must not waste management's time, and they need to be careful about inadvertently or intentionally giving direction, because seemingly innocent statements may affect executive or employee behavior. If directors learn something that causes them concern, they should raise it with the board or committee chair, or the CEO, rather than cause confusion by asking employees to stop or alter their activities.

## **6. WORK CONTINUALLY ON MODELING AND SUPPORTING A CULTURE THAT PROMOTES LONG-TERM THINKING, DISCIPLINE, AND ACCOUNTABILITY.**

Management shapes the institution's culture. The board and management should articulate the foundational principles or values of the culture and foster their acceptance. The messages need to be consistent at all levels of the institution, for a decade or more,

to have full effect. In addition to explaining what is expected of employees, members of management should model the desired behaviors.

Beyond the core ethical values, management must promote a sustainable, client-driven business, focused on the long term. Too often, boards and management teams—and shareholders—are overly preoccupied with the short term, not just because of analyst pressure for short-term performance, but also because the short-term objectives make it possible to reach the longer-term goals. Often, management considers three to five years to be long term.

The CEO and his or her team feel the short-term pressures the most. The CEO and management team need to deal with the inevitable and important short-term objectives that make it possible to reach the longer-term goals, but they must also focus on the next five to 20 years. They must be clear on what type of institution they want to build and what core behaviors need to be embedded in the organization to achieve the long-term strategic aim. In devising their long-term strategy, management has to be attentive to a broad set of stakeholders beyond shareholders, including employees, customers, and supervisors. Once the long-term strategy is determined and communicated to the firm's key stakeholders, the board and management must have the strength to say no to pressure exerted by short-term shareholders and sell-side analysts, among others.

Management must also instill discipline across the organization regarding objectives, focusing on businesses and jurisdictions that the firm knows well and in which it has or can develop competitive advantage. This discipline is backed up by clear accountability, which requires individuals to take responsibility for their actions and for achievement of set goals. Accountability starts at the top: CEOs are accountable to their board for their performance and that of their firms.

## **7. ENCOURAGE A CULTURE OF NO SURPRISES, QUICK ELEVATION OF ISSUES, TOLERATION OF MISTAKES, ORGANIZATIONAL LEARNING, AND PUNISHMENT OF MALFEASANCE.**

Management must be open and transparent with the board and should promote that approach throughout the organization. Only when management teams share their concerns openly, and in a timely fashion, can the board understand the issues and provide input or direction. Executives and employees should bring bad news forward, not hide it.

For openness to work, boards and executives need to be tolerant of mistakes and of honest attempts to do the right thing. Everyone needs to be encouraged to escalate issues to their managers, so decisions can be taken with more input. A no-surprises approach is paramount. Elevating problems quickly and early on will give the board confidence in management, and the same goes for others further down the organization. The emphasis should be on making more informed decisions. After problems are dealt with, the focus should be on determining whether corrective action is necessary to avoid future problems and whether systemic issues have been unearthed that go beyond the issue at hand.

However, there should be no tolerance for those who hide or suppress problems. When someone has been dishonest or has willfully done something wrong, management must see that disciplinary measures are taken, even (or especially) if the guilty parties are rainmakers. Sanctions have to be used, and used consistently, if they are to have a deterrent effect.

## **8. BUILD A TRUST-BASED ENVIRONMENT THAT SUPPORTS CRITICAL CHALLENGE AND IS OPEN TO CHANGE.**

Executives must be prepared for tough questioning and must understand that it is the board's duty to challenge them. Management must respond to the challenge, not cower from or avoid it. Executives must be prepared for the board to reject a proposal. Being open to challenge is a sign of quality management.

Constructive challenge is everyone's responsibility and should be fostered across the organization, upward and downward. Everyone should refrain from defensiveness and should be amenable to changing their behavior when required. Executives must be self-critical, challenging their own views over time. This is particularly important for long-tenured CEOs, who can find it difficult to critique their own legacy.

Management's willingness to embrace challenges, tough questioning, requests for more analysis, and even rejections helps build the mutual trust between the board and executives that is essential for effective governance.

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Management must play a continuous proactive role in the overall governance process, upward to the board and downward throughout the organization and, despite the continuing formal constitutional deficiencies, the position of management in a two-tier board structure is in substance increasingly similar to that in a unitary board. Engagement on governance matters requires management's commitment and time, but the results are worth the effort: the board can be confident that it has a strong management team in place, one that needs overseeing, but not directing.

## CHAPTER 5

# *The Role and Responsibility of Supervisors*

*Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.*

FI regulation is undergoing a fundamental transformation globally. Rule-based regimes, regulatory approaches, and enforcement are changing, but so too is supervision, which focuses on oversight of the board and management. In the years prior to the 2008–2009 global financial crisis, what proved in the event to be greatly inadequate regulatory standards, above all in respect of capital and liquidity, were flanked by seriously inadequate supervision. The eventual outcome of this regulatory inadequacy and supervisory laxity was a series of banking failures on an unprecedented scale. After the crisis, central banks and supervisors have refocused their collective and individual efforts on FI regulation and supervision of systemically important institutions.

Global initiatives undertaken within the frameworks created by the Financial Stability Board, Basel III<sup>11</sup>, and national regulators have made substantial progress strengthening requirements for minimum capital and liquidity. These are essential and significant steps in shoring up the soundness of the financial system, and they understandably attract political, market, regulatory, and media attention. However, they need to be complemented by enhanced qualitative oversight of the performance and decision-making processes of major FIs. Qualitative oversight of this kind requires strong mutual trust among the supervisors, the boards, and the senior executives of major financial entities.

If an FI lacks trust in its supervisor, the tendency will be to communicate with the supervisor only as much as is required and to hold back from any further degrees of openness. The parallel tendency on the part of the supervisor will be to be suspicious and correspondingly more intrusive.

With trust, in contrast, a mutually beneficial relationship that involves the sharing of information, experience, and views can develop and flourish. On the side of the FI, such a relationship requires a build-up of confidence in and respect for the capability, professionalism, and style of the supervisor, while on the side of the supervisor, it requires the development of a sense of assurance that the chairman, board, CEO, and senior executive of the FI are committed to open, frank, and appropriately consultative regular dialogue. A trust-based relationship is not achieved through box-ticking conformity but through sustained effort over time on the part of both supervisors and FI boards.

All of this is fundamentally attitudinal and cultural. The development of a trust-based relationship is necessary to counterbalance the widespread current tendency to see repair of the financial system purely in terms of much more demanding ratios for capital, liquidity, and leverage. Although critically important, those elements alone will not enhance the health of major FIs or the whole financial system. Higher-quality supervision, based on a solid foundation of mutual respect and trust between supervisor and supervised, is also needed. Trust-based relationships will also be very valuable in addressing the next potential crisis, whatever it may be.

Many supervisors realize this and have begun to enhance their effectiveness in this area. Members of the Financial Stability Board's Supervisory Intensity and Effectiveness group stated in October 2011, *"More intense supervisory oversight is needed to evaluate the effectiveness of improved corporate governance, particularly risk governance, in affecting behavior and improvements in this area will be*

11 For details of the Basel III accord, its implementation, and economic impact, please see <http://www.bis.org/bcbs/basel3.htm>.

*ongoing and monitored.*"<sup>12</sup> If supervisors take the following steps, they will be able to discharge their governance oversight duties more effectively:

1. Understand the overall business, the strategy, and the risk appetite of each FI, and focus on FI reactions to real-world events.
2. Develop a sophisticated appreciation of how corporate governance works, including governance structures and processes, board composition and new director selection, and the internal dynamics of effective FI boards.
3. Develop trust-based relationships with senior executives and directors by regularly engaging them in informal dialogue on industry benchmarks, emerging systemic risks, and supervisory concerns.
4. Ensure boards and management govern effectively by setting realistic expectations of FI boards and adjusting regulatory guidance accordingly.
5. Avoid overstepping their supervisory role and allow the board and management to shoulder their respective responsibilities.

Taking the steps enumerated above will not be easy and will have costs associated with them. Supervisors will need to hire talent capable of carrying out the enhanced and more complex tasks being required of them, which will likely mean increased expenditures, and government authorities must be prepared for this. You cannot have good supervision on the cheap. Governments must address resource and skill gaps so that effective and balanced supervision of FIs can be achieved on a relatively rapid timetable, in keeping with the financial reform plans and supervision agendas that have been established by the G20 and the Financial Stability Board.

## **1. UNDERSTAND THE OVERALL BUSINESS, THE STRATEGY, AND THE RISK APPETITE OF EACH FI, AND FOCUS ON FI REACTIONS TO REAL-WORLD EVENTS.**

Supervisors are part of the risk governance framework, representing the public interest. To effectively oversee risk in FIs, supervisors need to understand not only the effectiveness of FIs' controls, risk limit structures, and compliance, but also their strategy, business plan, products, and risk appetite. Attaining this level of understanding will take time and requires that supervisors regularly ask questions about and examine FIs' strategy and business models, risk appetite, risk exposures, potential killer risks, and the FIs' risk culture. In particular, supervisors should do three things:

- ◆ **Understand performance expectations and look for areas of unexpected outperformance.** In the build-up to the financial crisis, relative outperformance of particular businesses should have been a warning sign. Supervisors should understand target returns on equity for different lines of business, where those businesses make money, which businesses are performing particularly well, and especially which businesses are performing unexpectedly well. Supervisors should ask senior management and the board whether the returns are sustainable and compare the returns with those of peers in similar businesses.
- ◆ **Improve stress testing and increase use of horizontal reviews.** Cross-industry, cross-border stress testing is a useful supervisory tool that could be further improved through better coordination across borders and more agreement on

12 Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Progress Report on Implementing the Recommendations on Enhanced Supervision* (Basel: Financial Stability Board, 2011), 17.



key elements of the stress scenarios. By conducting more industrywide horizontal reviews<sup>13</sup> or deep dives into specific areas, supervisors can gain a better sense of relative risk and differences in approach across institutions. They should be willing to share with FIs more information about where the FIs stand in relative terms.

- ◆ **Focus on FI reactions to real-world events.** As important as stress testing and scenario analysis is how FIs react to actual stress events. FI reactions to emerging risks are an important indicator of their ability to withstand exogenous stress.

Through these endeavors, supervisors will develop a sense for which institutions have higher-risk business models and will then be able to increase monitoring and questioning of those institutions and where necessary to communicate their concerns to board and management. (For more detail, see Chapter 3: Risk Governance: A Distinctive and Crucial Element of FI Governance. See also Chapter 7: The Impact of Values and Culture on Behaviors and Decisions.)

## **2. DEVELOP A SOPHISTICATED APPRECIATION OF HOW CORPORATE GOVERNANCE WORKS, INCLUDING GOVERNANCE STRUCTURES AND PROCESSES, BOARD COMPOSITION AND NEW DIRECTOR SELECTION, AND THE INTERNAL DYNAMICS OF EFFECTIVE FI BOARDS.**

Supervisors must develop an understanding of how governance really works in each FI—not just the systems and processes, but also who the key people

are and how they interact. Gaining a more nuanced and sophisticated understanding of how governance in FIs works in practice can be broken down into four components: understanding governance structures and processes, understanding board composition and new director selection, recognizing how effective board challenge occurs, and attending board and committee meetings, but only occasionally.

### **Understanding governance structures and processes**

Supervisors should review the size and composition of the board and its committees, noting what skills and experience individual directors bring. Supervisors should also know the committees' mandates as laid out in their charters and how responsibilities are divided among them. Supervisors can glean information by reviewing board books, and by prereading presentation materials, board and committee meeting agendas, and board and committee meeting minutes. They should also discuss the results of internal and third-party board evaluations with the chairman to understand how identified weaknesses are being addressed. (For more on board evaluations, see Chapter 2: The Vital Role of Boards of Directors.)

### **Understanding board composition and new director selection**

The quality of the people involved in governance is the key determining factor of its effectiveness. Supervisors should understand the qualifications of the people who serve in key executive and board roles. Beyond that, they should be aware of how those people interact and the behaviors they display. The main issue for supervisors is not quantitative, but

13 The Financial Stability Board defines a horizontal review as a review “that is performed across many institutions around a common subject with the goal of revealing the range of practice among the firms.” Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* (Basel: Financial Stability Board, 2010), 7.



qualitative: Ultimately, are the people positioned to make sound judgments? (For more on board composition and expertise, see Chapter 2: The Vital Role of Boards of Directors.)

In some countries, regulatory approval of any new directors and some senior executives is required. In others, supervisors are getting more deeply involved in the vetting and approval of new directors and some executive functions. It is beneficial to have supervisors informed in a timely fashion of potential new director candidates, prior to the candidates' formal nomination. If the supervisor has views on specific candidates, those views should be shared with the FI. It is for the board's nominating committee to determine how they will incorporate the supervisor's feedback. Involving the supervisor in this way helps enhance the discipline, rigor, and quality of the process of director selection—without appropriating responsibility for the ultimate decision. That responsibility belongs to the board, and in particular to the chairman and the nominating committee. There is a case to be made for a supervisory veto if the supervisor believes that a proposed new board member would be unsuitable, but any greater supervisory intervention would not be beneficial.

At a minimum, supervisors should be familiar with the internal processes by which FIs select directors and the qualities they look for. Then, supervisors can look at the outcome and determine if the board's decisions reflect what the FI is trying to accomplish. Supervisors should also be aware of the different roles directors play and how the directors stay informed. They should consider how long various directors have served, new director training and ongoing educational programs, and how easily directors with questions or concerns are able to gain access to information and to management.

## **Recognizing how effective board challenge occurs**

Reviews of governance since the financial crisis have highlighted the failure of boards to challenge management sufficiently. Supervisors must understand the key issues that confront the FI board, gauge whether the board is capable of challenging management, and look for evidence of this challenge.

However, identifying clear evidence of challenge is generally not straightforward. It is all too tempting to rely on indicators such as the number of times the board said no to or argued vehemently against management proposals. In fact, too many no's from the board is more likely a sign of dysfunction. Antagonistic behavior between the board and management is not a sign of challenge; it is a sign of dysfunctional governance. Healthy challenge may come in the form of a question or series of questions, requests for additional information, a suggestion that management revise a proposal for further discussion, or further feedback in an in-camera session with the CEO or management team members.

To understand the distinction between constructive challenge and dysfunction, supervisors must become familiar with how the board and management interact and the full range of discussion, debate, and information sharing whereby the board directly and indirectly impacts management's decisions. Supervisors should look for signs of healthy tension influencing outcomes and be aware of management and board perceptions of how the board has impacted past decisions. Supervisors often focus on informational inputs to the board, but they should also focus on outcomes, which in the governance process are judgments. In other words, they should understand the full process by which boards reach judgments. Supervisors should

review documents and processes and should talk to management and the board to determine whether boards are providing challenge and affecting outcomes. Supervisors might ask, for example, for specific, recent examples of how the board impacted a significant decision.

### **Attending board and committee meetings, but only occasionally**

Most supervisors lack firsthand boardroom experience. One obvious way to gain a better sense of the inner workings of the boardroom would be to sit in on more board and committee meetings.<sup>14</sup> However, having supervisors sit in on meetings has a drawback: it is likely to alter the boardroom dynamic. Directors may hesitate to ask critical questions in front of supervisors, and discussion and debate may be inhibited. It may even move to other venues altogether. Sitting in on board meetings also raises questions of accountability: if supervisors are present when decisions are made and do not intervene, they take on some responsibility for those decisions. Therefore, although supervisors should reserve the right to attend board meetings, it is probably best if they do not do so as regularly.

Assessing governance effectiveness is not easy. One non-executive director summed it up by saying, *“It is near impossible to tell if governance is effective. Regulators [and supervisors] should understand what is truly vital to the [FI’s] success and what limits need to be applied. They should look at the corporate body and understand the primary risks that could kill it. They should check that the board understands the primary risks that could kill it. They should check that the board understands that.”*

### **3. DEVELOP TRUST-BASED RELATIONSHIPS WITH SENIOR EXECUTIVES AND DIRECTORS BY REGULARLY ENGAGING THEM IN AN INFORMAL DIALOGUE ON INDUSTRY BENCHMARKS, EMERGING SYSTEMIC RISKS, AND SUPERVISORY CONCERNS.**

Supervisors would benefit in their quest to gain insight into strategic risks and governance in FIs by broadening the types of interactions they have with management and directors. Informal conversations and sharing of supervisory perspectives are two examples of possible supplemental interactions.

#### **Regularly engage senior executives and directors in informal dialogue**

Supervisory institutions should assign a lead senior supervisor to oversee the supervisory staff in each large FI. This senior supervisor should decide the priorities of examination and try to establish a mutually respectful relationship with the board and senior executives.<sup>15</sup> All parties (management, board members, and the supervisor) must be open to building this relationship and commit the time required to do so.

Senior supervisors should meet informally with the chairman or lead or senior independent director and key committee chairs two or three times a year, and with other non-executive directors less frequently. The lead supervisor should meet with the full board at least annually. These interactions between non-executive directors—individual or group meetings—should be conducted with management present. Supervisors should discuss any concerns they have with the directors.

<sup>14</sup> Some supervisors, including those in China and Germany, regularly attend every board meeting.

<sup>15</sup> Domestic supervisors will need to determine the criteria for establishing more intensive supervision. The criteria may align with global and national efforts to identify systemically important financial institutions, or they may extend beyond those FIs.

Supervisors should meet with CEOs, CROs, and other key senior executives from the business lines and control functions several times a year to raise any questions or concerns directly and to allow the executives and directors to respond. This dialogue should be in addition to formal board presentations. This engagement will open channels of communication and establish regular dialogue in advance of any issues that may arise; however, they should avoid overburdening management.

The benefits of this dialogue include a better awareness of how governance works in practice, better relationships with and perspectives on key executives and directors, improved insight into potential systemic risks, and an unvarnished exchange of perspectives between supervisors and directors.

### **Offer the supervisory perspective and industry benchmarks**

Supervisors have the competence and authority to provide benchmarking, which will prompt boards to push for improvements from management. Supervisors have a broad, cross-industry perspective and can provide useful insight to FIs that can lead to overall improvements in the industry. They should leverage their global network to improve sharing of information and fruitful comparisons across jurisdictions and global institutions.

To facilitate this process, lead senior regulators and supervisors in each jurisdiction and across jurisdictions should meet periodically to share perspectives, highlight potential risks, and discuss good practice. On an international basis, coordination is becoming increasingly important to oversee complex, global FIs.

The Bank for International Settlements and the Financial Stability Board and various standards-setting bodies and agencies that meet under their aegis are working toward a greatly enhanced degree

of international coordination and cooperation, and the G30 commends and fully supports this ongoing process.

### **Share perspectives on emerging risks**

Supervisors are uniquely positioned to perceive emerging trends across institutions and potential systemic risks and should share concerns with the institutions they oversee.

### **Leveraging supervisory and auditor insight**

In the course of their independent work supervising and auditing financial institutions, the supervisor and external auditor each gather important insights on a broad set of matters, including—broadly defined—risks, controls, governance, culture, and tone at the top and across the organization. By sharing these views with the board and management, supervisors can help the board and management carry out their duties more effectively.

## **4. ENSURE BOARDS AND MANAGEMENT GOVERN EFFECTIVELY BY SETTING REALISTIC EXPECTATIONS OF FI BOARDS AND ADJUSTING REGULATORY GUIDANCE ACCORDINGLY.**

Some supervisors simply review an FI's structures and processes to ensure compliance with regulatory guidance, but simple "tick-the-box" evaluations of structures and processes do not sufficiently evaluate governance at large FIs. Other supervisors are electing to go a step further, observing and asking questions, and thereby pushing boards and management teams to make improvements and improve discipline. A realistic and nuanced approach to supervision has several components:

- ◆ **Clarity in the messages given.** Supervisors need to deliver a clear, consistent, and reasonable message regarding their expectations of boards. Regulators should clarify the distinct roles of board and management in regulatory guidance and ensure that supervisors do not interpret the guidance so conservatively that those distinctions are lost.
- ◆ **Reasonable expectations.** Pressure from regulators and supervisors can drive boards to a level of detail that is beyond their competency. It is one thing to support and encourage an active and engaged board that is properly familiar with the risks being taken by the organization; it is another to drive boards to an excessive focus on detailed operational matters that are more properly the purview of management.
- ◆ **Comprehension of the cultures and values that drive behavior in each FI.** Through their regular interactions with management and the board, supervisors can get a sense of the culture of an organization. They should consider how open and transparent management is with the board, how quickly issues are elevated, and how they are addressed when they come to light. Supervisors may have better insight into culture deeper into the organization than the board because they have staff working daily in these institutions. They can gauge how tone at the top is translated down through the organization.

Supervisors should avoid becoming so focused on an audit approach to assessing behaviors that they take isolated missteps as evidence of systemic issues, but they can offer insight into why isolated incidents might represent red flags for further investigation.

- ◆ **Thoughtful recommendations regarding governance improvements.** Although supervisors will better comprehend how FIs work through deeper engagement, they will never have an insider's perspective, and therefore they should set a relatively high bar for making specific recommendations for changes to governance structures and processes. If supervisors reach the conclusion that change is necessary, the formal process of informing institutions about recommended improvements should not be the end of the engagement process. A healthy relationship between the FI and the supervisor should allow for better communication of supervisors' questions and concerns and should make possible improved coordination regarding addressing those concerns and questions in the context of each FI's unique circumstances.

## 5. AVOID OVERSTEPPING THEIR SUPERVISORY ROLE AND ALLOW THE BOARD AND MANAGEMENT TO SHOULDER THEIR RESPECTIVE RESPONSIBILITIES.

Supervisors are becoming more proactive, and in some cases, more “intensive and intrusive,”<sup>16</sup> applying judgment and intervening earlier in decisions historically left to management and the board. In doing so, they must be careful not to compromise the clear fiduciary responsibility of the board to take its own commercial decisions on the direction and strategy of the FI within established regulatory parameters. Clarity around roles and expectations of the various actors in governance—management, the board, and supervisors—is essential.

Because they have a duty to prevent systemic problems, supervisors must sometimes stop an

16 See, for example, Hector Sants, “Reforming Supervisory Practices: Progress to Date,” speech at the Reuters Newsmakers Event, December 13, 2010; and Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* (Basel: Financial Stability Board, 2011).

institution from doing something. In this context, and despite the need to remain independent, in exceptional circumstances supervisors may (and some jurisdictions already do) consider the utility of direct intervention in strategic initiatives, if they believe the strategic shift presents undue systemic risk. At a minimum, supervisors should retain the right to review any major strategic initiative and to take such action if needed. Improving engagement with boards and senior executives should provide opportunities to air any concerns early in the decision process. This should reduce the need for intervention in decisions already made by management and the board.

As mentioned earlier, involvement of the supervisor in FI decisions raises issues of accountability. While supervisors must sometimes intervene, they must be mindful not to have that intervention adjust corporate strategy unintentionally. There have recently been examples of FIs selling subsidiaries just to avoid inappropriately intrusive supervision that had overstepped the boundary between supervision and board prerogatives. If supervisors are too closely engaged in key decisions, they take on some liability for those decisions. Similarly, there are dangers in overpromising. If supervisors claim they will successfully stop risky activities, then any activities not explicitly prohibited or stopped by supervisors may be perceived as acceptable. Supervisors must also avoid becoming “captured,” that is, overly influenced by the institution’s perspectives. Periodic rotation of senior supervisors among FIs can help prevent this phenomenon, though rotation should not be so frequent as to impede the development of knowledge, relationships, and insight.

Governments must address the talent and resource challenge created by enhanced supervisory goals and burdens. Staffing is a potential limitation that will need to be addressed, and so is compensation.

Regulatory agencies may wish to consider ways to attract more senior employees from FIs, including recent retirees, to augment the knowledge and

expertise of supervisory employees. While hires from FIs may create potential conflicts, the benefits of greater industry insight and expertise outweigh the potential drawbacks. Safeguards should be put in place to minimize even perceived conflicts of interest.

Regulatory and supervisory agencies may also wish to augment their independent analyses with internal work performed by the FIs themselves, including internal evaluation and audit work. Obviously, leveraging work performed by FI staff would require appropriate verification.

\* \* \*

Supervisory changes of the type proposed above are necessary and must be part of the financial reform and redesign process already under way. Taken together, the outlined supervisory good practices could significantly improve oversight of FIs.

Supervisors that more fully comprehend FI corporate governance structures, strategies and risks, culture, and operations will be better able to make judgments that support the stability of FIs in the face of unexpected crises or shocks. This enhanced supervisory discernment may also pay dividends by prompting increased vigilance and discipline within FI boards and management. The outcome should be increased stability of the financial system as a whole and effective microprudential oversight that complements the macroprudential goals of central banks and supervisors nationally and internationally.

Finally, it must be underscored once more that as supervisors take on this expanded role, they must be careful to respect the distinct roles that each stakeholder in effective governance has to play. The objective is to develop an optimal model of engagement, one that strengthens the governance framework overall without unduly burdening the board or management with supervisory intrusion or encroachment on management or board prerogative.



## CHAPTER 6

# *Relationships between FI Boards and Long-term Shareholders*



## *Long-term shareholders can and should contribute meaningfully to effective FI governance.*

This chapter offers perspectives on relationships between an FI board and its shareholders within a framework of effective governance. The focus is on suggested principles of general application (as far as possible) rather than on the specifics of ongoing debates in the United States and elsewhere on shareholder rights (for example, proxy access, staggered boards, board member terms, say on pay) and the laws and regulations that enable and constrain them in particular jurisdictions. Similarly, this chapter does not address change of control situations.

Significant long-term shareholders generally have the right to be represented on the board. These board members exercise their rights as they see fit, in accordance with the law, and they are to be applauded for the part they can and do play in assuring effective governance. The presence of long-term shareholders on the board leads to vigorous and salutary discussion, and significant shareholders almost always consider the long-term success of the institution to be paramount.

Those shareholders who are not represented on the board express their power and prerogatives largely (though not exclusively) through the exercise of their right to elect non-executive directors of the board. All shareholders have a right to be heard by management and the board and, at any rate in the case of long-only investors or their fund managers, an interest in promoting the long-term success of the firm. This interest and attendant responsibility may be seen as a counterpart to the core accountability of the board to them as shareholders.

Responsive boards and management teams engage seriously with shareholders, listen closely, and factor shareholder perspectives into decisions. Shareholders should insist on full transparency and disclosure on financial, compensation, and governance issues.

FIs with constructive relationships with shareholders:

1. Actively listen to shareholder perspectives and concerns before issues arise and communicate clearly the board's philosophy on governance matters of shareholder interest, including compensation, succession, and board composition.
2. Recognize that shareholders are a heterogeneous group and make every effort to honor shareholders' desire to be heard.
3. Thoughtfully manage their interactions with shareholders in the interest of clarity of message.
4. Decide when to resist shareholder demands, including those raised by proxy advisers, and when to accede to them.

The following points are also worth noting:

5. The UK's Financial Reporting Council has put forward a useful shareholder code, and the International Corporate Governance Network is supporting similar work.
6. Shareholders have an important role to play in shaping governance arrangements at FIs.

Details of how FIs engage in constructive relationships with shareholders, and of the other issues related to shareholders, are presented below.

## **1. ACTIVELY LISTEN TO SHAREHOLDER PERSPECTIVES AND CONCERNS BEFORE ISSUES ARISE AND COMMUNICATE CLEARLY THE BOARD'S PHILOSOPHY ON GOVERNANCE MATTERS OF SHAREHOLDER INTEREST, INCLUDING COMPENSATION, SUCCESSION, AND BOARD COMPOSITION.**

Shareholders can play a very important role in keeping the board and management honest about performance. Investors will forgive a lot, but they seldom forgive firms for failing to meet the expectations the firms themselves have set and conveyed. For this reason, dialogue with long-term investors is critical. Every major FI has a well-developed investor relations program, designed to accommodate its particular profile of investors. Investors usually want to talk about strategy and operations, so these programs are primarily the purview of management.

However, the board chair, deputy chair, and/or senior independent (lead) director also have key roles to play in communication with shareholders. Once or twice a year, the chairman and one or two other non-executive directors (for example, the lead or senior independent director, the chair of the governance committee, or the chair of the compensation committee) should consider meeting with the largest shareholders to cover any remaining questions or concerns. They should lay out the board's philosophy on governance issues, with a particular emphasis on identifying the chair's successor, plans to refresh the board, management succession planning, compensation, and any issues known to be on the minds of shareholders.

Some institutions invest considerable effort in framing and communicating their perspectives; others have a more difficult time justifying the expense necessary to do so. Many institutions rely on

proxy advisers for guidance. Some advisers are quite diligent; others are less so. Similarly, the reliance placed on them may be blind or well considered.

By engaging in active communication, boards will stay abreast of shareholder concerns. They will have a sense of the mood of the investor community. In those instances when shareholders' interests are not congruent with the long-term interests of the company, the board will be in a position to preempt unwelcome proxy resolutions through dialogue and early action.

## **2. RECOGNIZE THAT SHAREHOLDERS ARE A HETEROGENEOUS GROUP AND MAKE EVERY EFFORT TO HONOR SHAREHOLDERS' DESIRE TO BE HEARD.**

The shares of many of the world's largest FIs are widely held and traded on the major stock exchanges. Institutional investors (for example, investment and pension funds) hold many of the shares, but typically no one institution holds more than a small percentage of the total. These shareholders are a very heterogeneous group, and each acts in its own interests. Some hold shares for decades; others for seconds—as is the case for high-frequency traders for whom board engagement is of little or no interest. Some shareholders seek dividends, others long-term share appreciation. Some have special agendas. Many shareholders, for perfectly rational reasons, find it difficult to act like owners: they are simply investors, and as investors, some take an active interest in governance, while others do not.

As investors, shareholders' influence leading up to the crisis was not always positive. The Walker report summarized the situation clearly:

*“Before the recent crisis phase there seems to have been a widespread acquiescence by institutional investors and the market in the gearing up of the balance sheets of banks (and also of many other*

*companies) as a means of boosting returns on equity. This was not necessarily irrational from the standpoint of the immediate interest of shareholders who, in the leveraged limited liability business of a bank, receive all of the potential upside whereas their downside is limited to their equity stake, however much the bank loses overall in a catastrophe.”<sup>17</sup>*

Boards often have a legal or ethical responsibility to stakeholders other than shareholders. Employees have specific rights under codetermination. Customers have rights that are protected by laws and regulations, and by ethical considerations. The financial crisis surfaced the conflicting goals and rights of these different sets of stakeholders.

More broadly, given the externalities of FIs, boards have a duty to look after the broader interests of society, which tend to support the long-term interests of the FI and are broadly aligned with the interests of the long-term shareholder. All shareholders must be seen as just one of several categories of stakeholder, all of whose voices are important. Furthermore, shareholders themselves will be divided in their views. The wise board must understand all these motivations and strike the right balance among them.

### **3. THOUGHTFULLY MANAGE THEIR INTERACTIONS WITH SHAREHOLDERS IN THE INTEREST OF CLARITY OF MESSAGE.**

Conversations with shareholders need to be consistent, which is one reason why involving only a small number of non-executive directors in those conversations makes good sense: the possibility of confusion or ambiguity increases as the number of voices involved goes up. The independent chairman is the key liaison board member, with the senior

independent director or lead director often playing an important role as well. In addition, over the past few years, with so many shareholder questions arising on compensation, direct engagement between the remuneration committee chair and shareholders and proxy advisers has increased.

### **4. DECIDE WHEN TO RESIST SHAREHOLDER DEMANDS, INCLUDING THOSE RAISED BY PROXY ADVISORS, AND WHEN TO ACCEDE TO THEM.**

Not all shareholders will be happy with the firm’s governance philosophy and plans. Unhappy shareholders may file or threaten to file proxy resolutions. This may call for more communication and more information sharing.

The fact that in most cases shareholders can sell their holdings gives pause to board members and senior managers whom shareholders most want to influence. Rarely would anyone charged with building the long-term value of the firm want to encourage investors to sell their holdings. But board members and senior management cannot be swayed by near-term stock price pressures at the expense of the long term. In addition, paying special heed to a shareholder today who may sell his shares tomorrow seems unjustified. Shareholders’ relationship to the FI is more voluntary than that of any other group of stakeholders.

The board must choose and defend a position in the long-term interests of the institution, which is its primary responsibility. In discharging this responsibility, the board may from time to time act contrary to the wishes of short-term shareholders in order to create value for long-term shareholders.

<sup>17</sup> David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (London: HM Treasury, 2009), 71.

## 5. THE UK'S FINANCIAL REPORTING COUNCIL HAS PUT FORWARD A USEFUL SHAREHOLDER CODE, AND THE INTERNATIONAL CORPORATE GOVERNANCE NETWORK IS SUPPORTING SIMILAR WORK.

In July 2010, the UK's Financial Reporting Council published the UK Stewardship Code, which

*“aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. Engagement includes pursuing purposeful dialogue on strategy, performance and the management of risk, as well as on issues that are the immediate subject of votes at general meetings.”<sup>18</sup>*

The Code has been implemented in the UK on a “comply or explain” basis, which recognizes that certain shareholders may have good and substantive reasons for opting out.

In a similar vein, the International Corporate Governance Network has taken up the challenge of establishing best practice for shareholder responsibility and is lending its support to the development of stewardship codes and their equivalents around the world. This is a praiseworthy endeavor.

Institutional investors globally would do well to carefully consider the work of both organizations. They should comply with the Financial Reporting Council's Stewardship Code whenever compliance is consistent with the investor's aims and the constraints under which it operates.

Under the rubric of shareholder responsibility, two areas call for special attention and focus:

- ◆ The first relates to board composition, new board member appointments, and the evaluation of board performance, which many SIFI boards now undertake on a regular basis, increasingly

with the benefit of external facilitation. Major shareholders can benefit by factoring appraisal outcomes and follow-up initiatives into their dialogue with board chairmen. The chairman or lead director/senior independent director of a major SIFI board should give serious consideration to at least informal soundings with major shareholders before significant new board appointments are made.

- ◆ The second relates to the structure and incentives associated with remuneration. Say-on-pay measures in place in many jurisdictions invite shareholder engagement in the vital matters of how reward is structured and how it is allocated to employees (as opposed to shareholders). Even when express provisions for shareholder say-on-pay are not embedded in law or practice, shareholders can be encouraged to weigh in with a considered perspective.

## 6. SHAREHOLDERS HAVE AN IMPORTANT ROLE TO PLAY IN SHAPING GOVERNANCE ARRANGEMENTS AT FIS.

Shareholders can ask probing questions about governance that stimulate thinking, offer helpful observations, and otherwise support the FI. They not only have a right to be heard, they have an important voice in the governance process.

Institutional shareholders are seldom in a position to fully understand the issues facing the FI, be they strategic or governance related. They are simply too far removed from the action. When one considers that even board members, who may spend 30 to 100 days per year in the role, immersed in information and engaged with management, sometimes have difficulty understanding the real issues, one can better understand the limitations on shareholders.

<sup>18</sup> Financial Reporting Council, *The UK Stewardship Code* (London: Financial Reporting Council, 2010), 1.

Shareholders tend to act after there is a problem, but they rarely are able to contribute in advance. They are therefore not likely to make a real difference to the safety and soundness of the institution directly.

\* \* \*

Shareholders can and do contribute meaningfully to the effective governance of FIs. Significant,

long-term shareholders with seats on the board have both the position and the incentive to contribute positively to governance. Boards and management must diligently listen to them. But the role of institutional shareholders in securing financial stability through intervention on governance issues is nonetheless limited. The primary focus must remain on the board.

## CHAPTER 7

# *The Impact of Values and Culture on Behaviors and Decisions*

*Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.*

Structures and processes are important, but how they are made to function is the key. Suitable structures and processes are a necessary but not a sufficient condition for good governance, which critically depends also on patterns of behavior. Behavioral patterns depend in turn on the extent to which values such as integrity, independence of thought, and respect for the views of others are embedded in the institutional culture.

FI leaders stress the paramount importance of values and culture in driving behavior. Establishing proper institutional arrangements is relatively easy, but embedding the right culture tends to be much harder. In the best-run FIs, positive values and culture are palpable from the board to the executive suite to the front line. Values and culture drive people to do the right thing even when no one is looking. They are a fundamental aspect of the governance system.

Although values and culture cannot always be measured quantitatively, they impact governance effectiveness in powerful ways and therefore should be a major focus for the supervisor. What follows are specific views and recommendations designed to encourage FI board members, executive leaders, supervisors, and shareholders to pay heed to the importance of values and culture and the hard work involved in getting them right:

1. Honesty, integrity, proper motivations, independence of thought, respect for the ideas of others, openness/transparency, the courage to speak out and act, and trust are the bedrock values of effective governance.
2. It is for the board of directors to articulate and senior executives to promote a culture that embeds these values from the top to the bottom of the entity. Culture is values brought to life.
3. Well-functioning boards set, promulgate, and embed these values, commonly in the form of a code, so that directors, senior executives, and all other employees in an entity are fully aware of the standards of behavior that are expected of them.
4. Because of their power to influence behavior and the execution of the FI's strategy, values and culture are essential dimensions of inquiry and engagement for supervisors. Major shareholders or their fund managers should be attentive to the culture of an entity when making their investment decisions and engaging with an investee board.

These ideas are discussed in the pages that follow.



## **1. HONESTY, INTEGRITY, PROPER MOTIVATIONS, INDEPENDENCE OF THOUGHT, RESPECT FOR THE IDEAS OF OTHERS, OPENNESS/TRANSPARENCY, THE COURAGE TO SPEAK OUT AND ACT, AND TRUST ARE THE BEDROCK VALUES OF EFFECTIVE GOVERNANCE.**

All around the globe, across countries and cultures, FI leaders cited a remarkably consistent set of values that they considered to be essential to a culture in which effective governance could thrive. These include personal values, values concerning respect for ideas, values that shape personal interaction, and trust and mutual respect.

### **Personal values**

Absent impeccable personal values—honesty, personal integrity, and motivation—nothing is possible. Honesty and personal integrity are self-explanatory and important in any business, but especially in FIs, where public trust and a reputation for honesty and integrity are essential to the value proposition. Motivation deserves a short explanation.

Behavior can be motivated by factors both noble and ignoble. Self-interest is not intrinsically bad; it can be harnessed for good. But unless it is aligned with an orientation toward the firm, it will undermine objectivity and corrupt action. Motivation matters at the front line and in the executive suite. For example:

- ◆ The CEO may promote a major acquisition as a way to advance the long-term interests of the FI and its customers—or as a way to cap his or her legacy. The board needs to understand what motivates the CEO's recommendations and decisions.
- ◆ Frontline employees may recommend a loan for approval because they believe in the credit or just

to fill a quota. Traders may make a risky transaction because their compensation is tied to volume or because they are exploring innovative ways to make a profit for the FI.

Motivation, therefore, needs to be discerned.

### **Values concerning respect for ideas**

Independence of thought and respect for the views of others are values that relate to ideas, curiosity, and continuous learning. Good governance requires a certain democracy within the company. More voices need to be heard, both within management and at the board level. Consensus is often better than mandated CEO or board decisions.

Succumbing uncritically to groupthink or being too ready to accept the views of others, however, can be just as harmful as having a closed mind to others' ideas. Good board members, branch managers, risk managers, and CEOs must all be open to good ideas, but no ideas must be above challenge and dissection.

The CEO and chair carry a special obligation to be open to ideas from all quarters and to be oriented to the institution and its success. One CEO expressed this idea simply: *"I don't want to be right. I want us to do the right thing."*

### **Values that shape personal interaction**

Transparency/openness and the courage to speak out and act are values that shape personal interaction. Effective governance requires transparency, starting with information flows and discussion between the board and management. The relationship between the non-executive chairman, the non-executive directors, and management needs to be open, transparent, and honest.

Transparency is important in all relationships: between the chair and the CEO, between the risk

managers and the revenue generators, between each level of management, and between management and the supervisors. All employees should be responsible for risks in the FI; they should all try to act like auditors. This vigilance demands a commitment to transparency and openness.

Courage to speak up and act is the value that animates insight. A board member, risk officer, or branch manager might have a tremendously valuable insight or perspective, but without the courage to share it or act upon it, the insight is worthless. The board should be deeply aware of what is taking place and should be challenging strategy and risk policies.

It takes courage to mount a challenge in the boardroom, and it often comes down to the personalities of key players. Do the chairman and CEO encourage challenge? If not, that authoritarian attitude swiftly corrupts board behaviors.

### **Trust and mutual respect**

Trust must be earned. It is built on the application of the other values and develops over time. Trust and mutual respect go hand in hand and are always two-way. They are a feature of any strong organization. The board must trust and respect management, and vice versa. There must be mutual trust among management levels and among board members; there must be trust between the FI and its supervisors.

An example illustrates the point. There are always shades of grey regarding what information management shares with the non-executive directors and when. Early dialogue is most effective, but that is exactly when management does not necessarily bring a fully backed recommendation. If the board criticizes management for gaps or flaws in its analysis, these early discussions become increasingly rare. By contrast, if the board uses the opportunity to provide useful input and guidance, management will see the board as a genuine value enhancer.

Trust has a critical dimension not only at the board and senior management levels but also closer to the front line. Employees should have a means of raising questions and concerns and be given support without fear of retribution. Trust does not obviate the need for rigorous risk governance and personnel processes, but without trust, any system of governance is bound to fail.

## **2. IT IS FOR THE BOARD OF DIRECTORS TO ARTICULATE AND SENIOR EXECUTIVES TO PROMOTE A CULTURE THAT EMBEDS THESE VALUES FROM THE TOP TO THE BOTTOM OF THE ENTITY. CULTURE IS VALUES BROUGHT TO LIFE.**

Cultures are developed from a combination of values and priorities, both explicit and implicit, that together define how the organization acts. Culture influences attitude and behavior. If culture is developed well, decisions can be delegated much more deeply into the organization because people will know what is acceptable and what is out of bounds, even in the absence of close supervision or rules. Four aspects of FI culture have special relevance to governance effectiveness: risk culture, performance culture, customer-centricity, and societal responsibility.

### **Risk Culture**

As observed in Chapter 3, nurturing an appropriate risk culture is very important to every successful FI. Is the culture risk seeking or risk avoiding? Does it encourage pushing the envelope or remaining safely inside defined risk boundaries? Are known risks mitigated through unique skills or capabilities? Are risks taken outside permitted boundaries rewarded if they produce profits, or punished? Are risks widely syndicated, or is the risk culture more entrepreneurial?

Every FI will have a unique risk culture. Homogeneity is not a virtue. The risk culture must be consistent with and supportive of the FI's strategy and its long-term growth and stability.

## Performance Culture

Strong performance cultures can promote the success of an FI. Setting goals, measuring performance relative to them, and rewarding those who achieve goals is a core process in any organization. Every FI's performance culture has both organizational and individual performance dimensions.

Strong performance cultures tend to have quantifiable goals and "up or out" systems of advancement, among other characteristics. Steep incentive compensation arrangements are frequently a feature of strong performance cultures, but pay is by no means the only reward for performance. Advancement, recognition, and respect can also be very strong incentives and rewards.

The danger comes when the drive to achieve economic performance trumps or distorts core values and other cultural norms. A good performance culture will reward those whose successes uphold the organization's institutional values and penalize those who subvert those values. Economic performance at any price is failure.

## Customer-centricity

A customer-centered focus (customer-centricity) drives behaviors not only at the customer interface, but also in the marketing and product management of organizations. FIs that wish to distinguish themselves through superior customer service should make customer service the highest priority of a person's time. This is a strategic choice, not a governance issue, which is then translated into operational discipline.

The governance issues demanding board and executive attention concern the related issues of product suitability and business conduct, which manifest themselves in both the consumer and corporate segments.

- ◆ FIs must require that all products serve the legitimate needs of the target customer segment and be marketed accordingly. Information asymmetry will always exist—the FI will always know more than the client—but FIs must not exploit that asymmetry through aggressive marketing, because that may at a minimum create the appearance of deception.
- ◆ More broadly, ethical business conduct is essential everywhere, but especially in an FI licensed to operate by the state. Good business practice pays, and a firm following it will develop mutually beneficial relationships with all its stakeholders.

No FI can afford the reputational risk of marketing unsuitable product or engaging in slippery business conduct. Values and culture speak to both of these perils.

## Societal Responsibility

FIs, unlike most other corporations, are licensed by society to serve the needs of society. The 2008–2009 financial crisis demonstrated that an FI's mismanagement and collapse can have serious repercussions for the economy as a whole, which is why society requires FIs to take their societal responsibilities seriously and factor them into their culture. FIs must serve not only their shareholders, but society as a whole. This is a bedrock principle.

Accordingly, FIs must create a culture that respects those societal responsibilities and encourages the behaviors necessary to discharge them. This essential cultural bias toward society complements

the responsibility of the board to deliver value to shareholders, and it must shape top management's approach to FI strategy and risk, guide the board's oversight function, and define the supervisor's mission.

### **3. WELL-FUNCTIONING BOARDS SET, PROMULGATE, AND EMBED THESE VALUES, COMMONLY IN THE FORM OF A CODE, SO THAT DIRECTORS, SENIOR EXECUTIVES, AND ALL OTHER EMPLOYEES IN AN ENTITY ARE FULLY AWARE OF THE STANDARDS OF BEHAVIOR THAT ARE EXPECTED OF THEM.**

Setting values and shaping a culture takes a long time and a great deal of work. In discussing the keys to effective risk governance, one chairman noted, *"The remaining 30 percent to 40 percent is culture, getting people in the right mindset. How do you build up the right culture, where people self-regulate?"*

A written code helps preserve and strengthen the culture: it is the FI's tangible symbol of its value system and can be prominently and widely displayed such that it draws attention and comment from employees. The code should emphasize the positive commercial benefits of high standards of ethical business conduct and not simply the negative consequences of getting things wrong.

Constant reminders and repetition are the keys to embedding a culture. A powerful and essential way of doing so is to visibly integrate values and culture into the key HR processes of the FI. These processes are among the most influential and tangible reinforcing mechanisms because through HR actions aspirational statements become reality. For example:

- ◆ Recruiting material and interview guides need to refer to the code so that candidates understand what kind of company it is they are seeking to join.
- ◆ The employee induction process needs to include substantial attention to the code and how it affects expected behaviors.
- ◆ The performance review process needs to meaningfully incorporate consideration of an individual's conformance to the FI's values. Metrics must be put in place. Often, 360-degree reviews on softer issues can bring to light both strengths and weaknesses.
- ◆ Advancement decisions invariably send loud messages to the organization about who can expect to do well in the organization. It takes courage to penalize someone for subverting values when that person has also been responsible for great economic performance. On the other hand, advancing a "culture carrier"—an individual who not only achieves strong economic performance, but does it the right way—sends a strong positive message.

While values and culture may be the "soft" side of governance effectiveness, they can and must be managed with hard and dedicated commitment.

### **4. BECAUSE OF THEIR POWER TO INFLUENCE BEHAVIOR AND THE EXECUTION OF THE FI'S STRATEGY, VALUES AND CULTURE ARE ESSENTIAL DIMENSIONS OF INQUIRY AND ENGAGEMENT FOR SUPERVISORS. MAJOR SHAREHOLDERS OR THEIR FUND MANAGERS SHOULD BE ATTENTIVE TO THE CULTURE WHEN MAKING INVESTMENT DECISIONS AND ENGAGING WITH AN INVESTEE BOARD.**

Values and culture are legitimate and important dimensions of inquiry for supervisors. While these soft features defy quantitative measurement, they cannot be ignored. Anyone spending time in an organization quickly develops a clear sense for

what drives it: most new employees understand the values and culture of the institution within a year, and many figure it out within a few months. They instinctively observe how values and culture influence day-to-day business decisions and personnel choices. Supervisors can do likewise.

Supervisors need to understand each FI's values and culture. It should be one of the things they articulate about the FI, and they should compare and contrast their perceptions with those of their colleagues who work with other FIs. Supervisors should discuss their observations with senior managers and board members from time to time. If the supervisors have concerns, they should express them through appropriate channels and customary forums, but they should resist making recommendations regarding what values and culture an FI should cultivate. Those are decisions for the board and for management.

Finally, long-term shareholders need to be attentive to culture and treat it as an investment criterion. Believing in the long-term prospects of an institution involves buying into its values and culture.

\* \* \*

Values and culture should be seen as the ultimate software that determines the behaviors of people throughout the FI and the effectiveness of its governance arrangements. The fact that the quality of embedded values and culture cannot readily be measured does not detract in any way from their critical significance. Boards, management, supervisors, and shareholders must be continuously and proactively attentive to the maintenance and reinforcement of values and cultures that lead to safe, sound, innovative, ethical, and high-performing FIs.



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