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Bank governance: too important to be left to banks

1. Summary

In July 2011, The European Commission proposed reforms for the corporate governance of financial institutions[1]. Transparency International (TI) supports these reform measures, but considers them incomplete. An effective corporate governance system should be buttressed by measures that improve public disclosure on key risks, reinforce responsibilities of directors and strengthen shareholder democracy.

2. Background

TI has a long experience of working with private corporations to build integrity and responsible behaviour. It has found that good corporate governance is the key to managing risks that threaten integrity. Incidents of bribery, conflicts of interest, fraud and other forms of corruption are signs that corporate governance – and the integrity system more broadly - is not functioning.

The 2008 financial crisis revealed striking flaws in the governance of banks and other financial institutions. This manifested itself in excessive risk-taking, poor controls, pervasive conflict of interest and cases of fraud. These deficiencies were evident before the onset of the crisis and have not been remedied sufficiently. Recent trading losses amounting to billions at one institution show that banks have failed to learn lessons about effective risk management and internal controls.

TI welcomes the European Commission's proposals to introduce an enhanced corporate governance regime for the financial sector. The focus on the responsibilities, skills and composition of board members, realigning incentives and executive remuneration and enhanced internal controls (in particular whistle-blowing and risk management procedures) will result in more stable and better managed institutions and is in line with TI's previous recommendations on this topic. But crucial elements are missing if Europe's financial sector is to avoid the mistakes of the past. Importantly, the role of transparency and public disclosure in providing external checks has been overlooked.

3. Why the governance of financial institutions requires special attention

Financial institutions differ from other businesses because of the larger number of stakeholders, the complexity of their operations the high cost of failure (large externalities) and the critical role of trust and reputation in both the system and the individual institutions. Stakeholders include shareholders and employees, of course, but also depositors, debt holders, the government (both as regulator and guarantor through the deposit guarantee scheme) and, to the extent that banks are considered "too big to fail", the taxpayer. Since the deregulation of the 1980s and 1990s, financial institutions have become more complex and opaque as the number of activities has multiplied and as financial innovation has gathered pace. This complexity provides a particular

[1] Directive on the Access to Activity of Credit Institutions and the Prudential Supervision of Financial Institutions, COM (2011) 453/3

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challenge to boards as they seek to assess and manage risk. Finally, the cost of failure has been amply demonstrated by the recent bailouts by governments and intergovernmental institutions. All this means that particular attention must be paid to corporate governance of financial institutions, with more stringent requirements than in other sectors.

4. Why bank capital rules are no substitute for robust corporate governance

The Commission has published its corporate governance proposals at the same time as its proposed rules on bank capital. It is hoped that by improving the quantity and quality of the capital that banks are required to hold, this will create buffers to withstand future economic shocks and absorb losses. While such rules have been the focus of much debate since the 2008 crisis, they are no substitute for robust corporate governance arrangements for two reasons.

Firstly, a reliable assessment of the amount of capital an institution holds depends on the value of its assets[2]. Effective enforcement of the rules relies on robust asset selection and valuation standards at banks, both of which require sound and skilled judgement of risk managers and other managers, as well as supervisors. Ensuring that risk managers and supervisors can carry out such functions unimpeded and with the necessary information is a matter of the governance arrangements. Secondly, even the new capital requirements envisaged by Basel III and the European Commission do not take into account the ability of institutions to "game" the system by including weaker forms of capital that favour shareholders over other stakeholders, but could expose themselves to severe losses in future crises[3]. Avoiding such unsustainable strategies will require substantial reforms to corporate governance.

5. What has the European Commission got right?

TI welcomes the following Commission proposals:

Article 70 – Reporting of breaches: secure whistleblowing mechanisms are an important way to expose fraudulent or risky practices.

Article 75 – Treatment of risks: periodic review of an institution's risk strategy by senior management and the requirement to establish a strong, well-resourced and independent risk management function will help to avoid reckless leverage and other non-financial risks, such as bribery.

Article 86 – Governance arrangements: TI believes that the board of directors is one of the major elements of a successful corporate governance system. The clarification of the board's responsibility for risk strategy and internal governance and the separation of the roles of chair and CEO will avoid conflicts of interest and promote more prudent management.

[2] Capital is a residual. It is the difference between an institution's assets and liabilities.
[3] *Dividends and Bank Capital in the Financial Crisis of 2007-2009*, Acharya, Gujral and Shin, Journal of Applied Corporate Finance, 2011

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Article 87 – Management body: The focus on the adequacy of the board's collective skills, knowledge and experience and will improve their assessment of the main risks and promote a more contrarian and challenging body.

Articles 88, 90 – Remuneration policies: Restructuring compensation of senior staff in the manner specified will help to reduce the appetite for high-risk transactions and reward responsible, sustainable and long-term performance. This fundamental shift should be safeguarded by having remuneration policy subjected to annual independent review.

6. What more needs to be done?

Although the proposed reforms would be a step in the right direction, the Commission has omitted a number of concrete measures that would reinforce the corporate governance system they propose:

(i) Greater transparency and public disclosure

It is both unreasonable and undesirable to have the corporate governance of financial institutions policed only by regulators and supervisors. Unreasonable, because the complexity of financial conglomerates and their interconnections means that the limited resources of government agencies are quickly overwhelmed. Undesirable, because the financial crisis also revealed that the revolving doors between regulators and private institutions led to a blurring of roles, opaque decision making and conflicts of interest. Reliance on internal controls and traditional prudential supervision has failed the public before, even in the most advanced jurisdictions. The greater the number of stakeholders that can monitor an institution's performance and send appropriate signals to management, the better.

Such stakeholders include shareholders, investors, other market participants and civil society organisations, who can all react in different ways to revelations of high-risk and unsustainable strategies. The information can be used to inform potential policy responses and the adequacy of regulators' approaches too can be subject to stakeholders' comment.

Financial institutions should therefore be required to publicly disclose their activities in far greater detail. A recent study[4] has revealed several shortcomings regarding the transparency of the EU's top banks. There is a striking lack of detailed information on risk exposures to different business sectors, customer classes and off-balance sheet entities. Even relatively straightforward data, such as loans to public bodies, loans to SMEs, foreign currency exposures and liquidity conditions are hard to find in annual reports or financial statements. More detailed and standardised disclosure of banks' financial positions is necessary for a wider range of checks and balances to function, such as the ability of investors and creditors to monitor risk.

[4]Business Models in European Banking: a pre- and post-crisis screening, Centre for European Policy Studies (CEPS), 2011

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Detailed disclosure requirements would include:

- Publishing comprehensive data on key aspects of a financial institution's risk profile, e.g., credit exposure to other financial institutions (including off-balance sheet entities) and concentration, market and liquidity risks.

- Reporting on group structures and relationships and transactions between affiliates, to assess mutual dependencies and the risk of contagion.

- Reporting of quarterly averages of balance sheet categories, to avoid the misleading results that sometimes accompany single-day data.

- Greater disclosure of loan performance data and the provisions made for losses.

- Disclosure by banks of the models used to value assets.

- Reporting by regulators on key elements of supervisory review process, such as stress test data, capital add-on requirements and sanctions and warnings issued.

All such data should be made available on a quarterly basis in standardised formats for ease of comparison.

In addition, financial institutions should disclose in their annual reports the measures they are adopting to strengthen risk management at board level, including non-financial risk such as environmental and integrity standards, including anti-bribery programmes. A risk control declaration should be put in place and published.

(ii) Strengthened shareholder democracy

Strengthening shareholder democracy helps to create an accountability mechanism that combats corrupt and unsustainable actions by senior management. Shareholder rights should be reinforced and their participation in company meetings facilitated, including voting on changes to a company's structure (articles of incorporation) and important board decisions (board membership and remuneration policy).

(iii) Enhanced executive responsibility

The governance of financial institutions would be enhanced if their fiduciary duties were extended beyond the concern with shareholder maximisation. The Commission proposals refer to the board's responsibility to ensure "prudent management" and "risk strategy", but its responsibility for the safety and soundness of the institution should be explicitly acknowledged. Furthermore, it should be made clear that overall accountability for risk management programmes lies with the board in its entirety. Several board members should have an appropriate knowledge of the working and risks of financial products and services that are offered by their institution to customers.