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Guidance for the Directors of Banks

Richard Westlake, MA (Oxon.)

Foreword by Léo Goldschmidt



Global
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World Bank Group



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Guidance for the Directors of Banks

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About The Author

Richard Westlake is based in New Zealand, where he established Westlake Governance, an international governance advisory business, in 1999. He has more than 20 years' experience as a board chair and director and currently chairs several boards in different sectors. He has spent more than 30 years in the banking industry:

- As a money market dealer for a subsidiary of Chase Manhattan Bank;
- Corporate banking roles in New Zealand and Australia;
- Chief operating officer for Barclays PLC in New Zealand;
- Chief executive of a New Zealand regional bank; and
- Independent director of Kiwibank Ltd, and chair of the bank's finance, audit and risk committee from its establishment in 2002 until 2011.

Richard is keenly sought after as a facilitator and presenter of director development programs in New Zealand and internationally. Most recently he worked with IFC's Global Corporate Governance Forum on training-of-trainers programs in Indonesia, aimed particularly at building governance capability in the banking sector in Indonesia and East Asia.

Before moving from England to New Zealand, Richard gained his MA at Oxford University, where he won a Rowing "Blue" in the 1973 Oxford versus Cambridge Boat Race. He trained as a fighter pilot in the Royal Air Force, and his first leadership appointment, at age 22, was running a 4,500-person refugee camp in Cyprus.

Richard is an Accredited Fellow of the Institute of Directors in New Zealand and an International Fellow of Mudara – Institute of Directors in Dubai, United Arab Emirates. He is married with four adult children.

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Foreword

The world is already accustomed to the remarkable publications series of the IFC Global Corporate Governance Forum. This new *Guidance for the Directors of Banks* is a perfect complement to *Governing Banks*, published in 2010.

Much has changed since the late and greatly missed Jonathan Charkham wrote a first version more than a decade ago, and these changes warranted a thorough review. No better specialist could have been found for this review than Richard Westlake. The breadth of his knowledge, the wealth of his experience, and an unmistakable pedagogical talent combined to make this a most useful tool for the enlightenment of bank directors.

The reader will find in it not only many wise considerations regarding the assumption of a directorship in general, but also and more specifically the fundamentals that underpin a directorship in a bank, as distinct from other industries, together with a practical review of the elements that should be borne in mind to carry out that function properly and effectively.

The book is both comprehensive and concise, its style is appealing, and its ability to present sometimes complex issues with simplicity makes it eminently accessible to the lay as well as the learned. It also reflects the author's profound understanding of his profession as well as a rarer quality, common sense, that so many lack—as was evidenced once more during the global financial crisis. And finally it displays exceptional modesty, as for example where in his introduction Richard Westlake merely suggests that in addition to its main target audience—directors new to banking, new to holding a position on a bank board, or even new to ever holding a directorship—experienced directors of banks “may find the book a useful refresher.”

I for one, retired after 40 years as a practicing banker, having also chaired my national banks' association and taught banking at university, took the greatest of pleasure and derived much benefit from being privileged to read the manuscript of this excellent compendium.



Léo Goldschmidt

Member of the IFC Global Corporate Governance Forum's
Private Sector Advisory Group

Léo Goldschmidt has been a banker for more than 40 years. He continues to hold independent directorships in a number of companies and societies, including the European Corporate Governance Institute. He has participated in numerous corporate governance activities worldwide by chairing, among others, the Corporate Governance Committee of EASD (European Association of Securities Dealers), serving on the Organisation for Economic Co-operation and Development Corporate Governance Task Force, taking part in World Bank-OECD Roundtables, and giving lectures on corporate governance.

A Note from the Author

Last year IFC Global Corporate Governance Forum invited me to write an updated version of *Guidance for the Directors of Banks* (Guidance 2, published in 2003).¹ In the 10 years since the late Jonathan Charkham CBE wrote the first edition, the banking sector has seen the most dramatic business cycle in living memory — the almost unprecedented asset price boom that for many commodities and assets ended abruptly in about 2007, followed by the most sudden and deepest financial “meltdown” since the Great Depression of the 1930s. The effects of this financial crisis continue to dominate the economies of many countries.

I was delighted to be asked, but no assignment of this type is the work of only one person. First, I must thank Alexey Volynets and Ralitza Germanova from the Forum for their confidence in me, and their advice throughout the project. José Cruz-Osorio, Forum consultant, provided some excellent references and case studies and feedback. I also thank the reviewers, Léo Goldschmidt (a banker and renowned corporate governance practitioner), Gian Piero Cigna (Senior Counsel, EBRD), YRK Reddy (international consultant in strategy and corporate governance), Peter Rudman (Rudman Advisory), and Sergii Tryputen and Stefanus Handoyo (IFC), who provided helpful comments and advice on the various drafts.

I must acknowledge my friends and colleagues at the Institute of Directors in New Zealand, led by Chief Executive Officer Ralph Chivers. Much of my thinking has been refined through this longstanding relationship, and I consider that the Institute’s 2012 update of its *Four Pillars of Governance Best Practice* is one of the best toolkits for directors currently available anywhere.² I should also like to acknowledge my friend Richard Kirkland, Partner – Enterprise Risk Services at Deloitte in Wellington, who offered very helpful input to the section on risk and provided many reference materials.

Stephanie Rountree, my colleague, researcher, and technical writer, has done an immense amount of work to make the book a reality. She has taken notes, researched, drafted, critiqued, and ensured consistency and quality throughout. I would be more correct to describe her as the book’s coauthor.

Finally, my thanks go to Elaine Porter, my assistant in Westlake Governance and my patient wife the rest of the time, for her support as the drafts and final versions evolved.

Others I have not mentioned include my many fellow board members and chief executive officers in many companies and other organizations I have been a part of, and the experienced mentors who have frequently advised and counseled me through my career. There is no substitute for learning on the job — after 20 years in the boardroom I learn as much today as ever.

1. Jonathan Charkham CBE, *Focus 2: Guidance for the Directors of Banks* (IFC, 2003). Available at www.gcgf.org/publications.

2. Institute of Directors in New Zealand, *The Four Pillars of Governance Best Practice* (2012). <https://www.iod.org.nz/Publications/TheFourPillarsOfGovernanceBestPractice.aspx>.

To those whom I have not acknowledged, I apologize. And, since I have had the final say over the content, style, and opinions expressed, I accept sole responsibility for errors, inconsistencies, or gaps.

The views I have expressed through this book have evolved over many years in financial services and as a board chair and director. I do not expect everyone to agree with everything in here — but I hope that my work will inform the reader and provoke thought and discussion and, most importantly, that it will generate some intelligent questions in your bank’s boardroom.

If so, it has succeeded.

Glossary

Board Chair/ Chair: The director who is elected to the position of chair by a majority of the board of directors. The chair provides leadership to the board, presides over meetings, acts as a link between the board and senior management, and is spokesperson for the company on important issues.

Board Secretary/Company Secretary: The officer who serves the board in an administrative capacity, being responsible for board papers and their receipt by all board members, assisting with minutes, agenda construction, and board processes and procedures.

Chief Executive Officer (CEO): The executive usually appointed by, and accountable to, the board to manage the operation in accordance with the agreed strategic plan. When the CEO is also a board member, he or she is typically called a managing director (MD).

Chief Risk Officer (CRO): The executive accountable for the efficient and effective governance of significant risk and for ensuring that the company is compliant with government regulation.

Chief Financial Officer (CFO): The senior manager primarily responsible for managing the company's balance sheet, cash flow, and funding, and for managing the financial planning and accounting functions of a company. The CFO reports to the CEO and regularly interacts with the board of directors.

Corporate governance: The structures and processes for the direction and control of companies. The main elements of corporate governance are generally accepted to include strategy, performance monitoring, compliance, and accountability.

Director: A member of the governing board of the company.

- Executive directors are senior operation officers or managers of the company who are also members of the board, so they have the full range of a director's responsibilities and duties.
- A non-executive director does not have executive management responsibilities within the company, and may or may not qualify as an "independent director" (see below).
- An independent director is independent of management and free from any other business or other relationship or circumstance that could materially interfere with the exercise of that director's independent judgement.

Equity ratio: The ratio of shareholders' equity to total assets, usually expressed as a percentage (see also leverage ratio).

GFC: The GFC, the global financial crisis of 2007–2009, is regarded as the worst financial crisis since the Great Depression of the 1930s. Worldwide, major financial institutions collapsed and banks had to be bailed out by their governments.

Leverage ratio: The ratio of total assets to shareholders' equity, often expressed as a multiple (the reciprocal of the equity ratio — see above).

Liquidity: The ability to realize sufficient cash, from cash reserves or easily realized securities such as government treasury bonds, to cover the bank's immediate liabilities.

Related-party transaction (RPT): A business transaction where the two parties had a business, personal, or other relationship prior to the transaction, which might provide an incentive for the transaction to be agreed on other than fully commercial terms.

Risk governance: The processes, policies, and structures that underpin effective identification and management of risk, under which the board:

- Determines the company's risk appetite;
- Understands the risks the company faces, internally and externally;
- Accepts that managing risk is the board's ultimate responsibility; and
- Ensures that the board receives the information it needs to monitor strategies and performance and continually assess the implications.

Solvency: The ratio of total realizable assets to total liabilities. If this ratio is greater than 1:1, assets are greater than liabilities, so shareholders' equity is positive, and the bank is solvent. If realizable assets are less than total liabilities, the bank is (at least technically) insolvent.

Stakeholders: People, either internally or externally, who have an ability (directly or indirectly) to influence the performance of the company. These can include shareholders, share analysts, credit rating agencies, customers, employees, board members, suppliers, depositors, regulators, labor organizations, and units of government.

1. Introduction

The need for sound governance of banks worldwide has never been stronger. The Kabul Bank case may seem an isolated and extreme example. However, it has lessons for all bank directors—the need for continued diligence, the risks posed by dominant shareholders and large related-party transactions, the value of transparency in reporting, and the personal risk that all directors face if they don’t have the necessary skills and understanding. After the global financial crisis of 2007–2009 (GFC), spectacular bank failures—whether caused by greed, incompetence, or indifference—are still occurring.

I have designed this *Guidance for Directors of Banks* mainly for three groups of readers:

- New directors with experience in banking;
- Directors who understand governance, but have no experience in banking; and
- New directors who have no experience of either banking or being a director.

It is mainly an introduction for the directors of non-complex banks—whose main business is to take deposits and provide loans—and is not designed for the directors of large, complex banks or investment banks operating in global capital markets and dealing with complex corporate structures. I hope, however, that even relatively experienced directors of banks, and those who work with them, may find the book a useful refresher.

Since the late Jonathan Charkham CBE wrote the first edition of this Guidance book in 2003, the world has changed dramatically. During the GFC, many household-name banks merged or disappeared. Now there is stronger supervision of banks and greater expectations of boards,

The Kabul Bank Crisis, Afghanistan, 2010

In late 2012, a public inquiry revealed that the founder chair, the CEO, and other insiders in Kabul Bank had fraudulently funnelled hundreds of millions of dollars to shareholders, top Afghan officials, and themselves. This had caused a run on the bank in late 2010, necessitating a bailout by the Afghan government.

Of the \$900 million the bank officials spent, less than 10 percent has been recovered. Relative to the size of Afghanistan’s economy, this is the biggest banking scandal ever uncovered worldwide—representing more than 5 percent of the national income.

A public inquiry has suggested that more robust structures and procedures and better financial controls, including information about the bank’s managers, could have prevented this huge scale fraudulent activity.

so directors need to be knowledgeable about and engaged with their bank to provide direction and hold bank management to account.

The environment in which banks operate varies enormously between countries, so I have often generalized or referred to simple models to make my point. My main theme is that the core principles do not change. Regulations may change but the job of a director is constant. My main focus has been the fundamental responsibilities of a director — to exercise a reasonable level of care, loyalty, and relevant skills (often referred to as “a director’s fiduciary duty”).

As far as practicable, I have used standard banking terminology and included a glossary of some of the main terms used.

I trust that this Guide provides useful information and insights. However, on its own:

- It will not make a nonbanker into a banker, and
- It will not turn a manager, or anyone else with no governance experience, into a director.

I hope you enjoy it!

2. *Where Banks Fit in the Corporate Governance Framework*

The word “governance” has its origins in the Latin word for “helmsman” or “navigator,” so the essence of governance is to look ahead and chart the course for an enterprise. The so-called “Cadbury Code”³ defines corporate governance succinctly as “the system by which companies are directed and controlled,” and the responsibilities of the board as:

. . . [including] setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.

Building on the OECD’s work and with special reference to the banking and governance failures since 2007, the Basel Committee on Banking Supervision has developed its own 14 Principles for Enhancing Corporate Governance in Banks.⁴ (See Box 1.)

Corporate governance is different from management. The role of management is to run the enterprise and that of the board is to see that it is being run well and in the right direction.

(Robert Tricker, 1998)

The Board of Directors takes in the big picture by looking at and caring about the entire forest, leaving operations, the small details, and the individual trees to the charge of management.

(Jesus P. Estanislao, 2002)

Box 1: Basel Committee Definition of the Corporate Governance of Banks

“The allocation of authority and responsibilities, including how they:

- set the bank’s strategy and objectives;
- determine the bank’s risk tolerance/appetite;
- operate the bank’s business on a day-to-day basis;
- protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders, and
- align corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.”

Source: Basel Committee on Banking Supervision, *Principles for enhancing corporate governance* (Bank for International Settlements, October 2010).

3. The Report of the Committee on the Financial Aspects of Corporate Governance, s.2.5, 1992, chaired by Sir Adrian Cadbury, who influenced the worldwide reform of corporate governance in the 1990s.

4. The Basel-based Committee on Banking Supervision, *Principles for enhancing corporate governance* (Bank for International Settlements, October 2010). <http://www.bis.org/bcbs/index.htm>.

Sir Adrian Cadbury also sees the social dimension to a board's responsibilities:

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.⁵

Companies are legally distinct beings

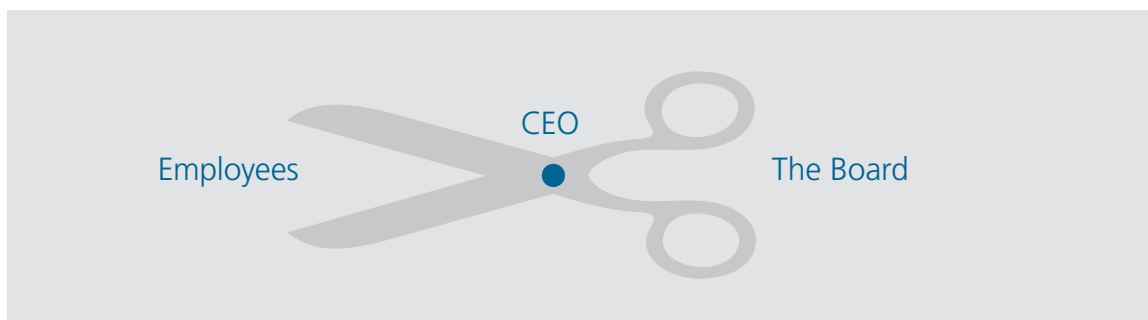
In law, a company has a legally separate existence, distinct from the people who own, direct, or work in it. However, the law generally assumes that a company, unlike a person, will continue indefinitely as a "going concern."

At the simplest level, a company is made up of three groups of people:

- Shareholders are the owners of the company. They have the right to hire and dismiss its directors, but it is not their job to run the company. A shareholder with a controlling interest may appoint himself or herself as a member of the board, but this is a different role with separate responsibilities. If the company is incorporated with limited liability, the shareholders will not usually be liable (beyond the limit of their shareholding) for the company's debts or other obligations: for example, unpaid creditors or breaches of the law.
- Directors have the legal responsibility for running the company. They share ultimate accountability for its wellbeing and, in some cases, may be held personally liable for its debts and obligations. Directors collectively compose the board of the company, and a decision of the board is generally a collective decision for which all directors are individually accountable. This may be the case even if a director has personally disagreed with the decision. Some or all of the directors may also be managers in the company.
- Management's main role is to put into practice the decisions of the board. It follows the direction set by the board and gets the job done. As indicated above, it is quite possible and common for individuals to fill two or even all three of these roles (owner, director, manager). In such cases it is important for them to understand, and distinguish, their rights and obligations in carrying out each role.

The chief executive officer (CEO) of a company is uniquely positioned as the only person accountable directly to the board. All other employees are accountable to the CEO. This relationship can be compared to the image of a pair of scissors, where the board (representing the handles) directs the actions of management (the cutting edge) through the pivot of the CEO:

5. A. Cadbury (Sir) at the Global Corporate Governance Forum (World Bank, 2000).



Bank ownership takes many forms

The ownership of banks can vary widely, across the range of corporate ownership structures, including:

- Privately owned by a family or one or more individuals
- A subsidiary of another company or group of companies
- A wholly or partly owned subsidiary of a foreign banking group
- State-owned enterprises, wholly or majority owned by the government
- Cooperative or mutual ownership, where the bank's depositors are also its owners
- Owned by a trust for public benefit
- A company with widely dispersed ownership, having its shares traded on a stock exchange

Concentration of control in a publically traded bank, through a series of related company shareholdings, may result in a single shareholder exercising more control than is obvious through the bank's share register. Depositors and bank regulators need to be wary of such structures, and directors of such banks can find themselves in a position where it becomes extremely difficult to act in the bank's interest if this differs from the interests of that controlling shareholder. A director should always be willing to resign if the board is unable to act independently and in the bank's best interest.

Banks may have dominant and influential shareholders

In some countries, the banking industry is dominated, or at least heavily represented, by banks that operate as local subsidiaries of foreign banking groups. In 2008, foreign banks held more than 80 percent market share in Albania, the Czech Republic, Poland, and Georgia (among others). In contrast, some countries, typically in Africa and the Arab world, have banking systems where the government is a dominant (often the sole) shareholder. In yet others, for example, Indonesia and Mexico, a few families may own and control a significant proportion of the banking sector.

However, in most if not all jurisdictions the main duties and obligations of directors of banks do not vary, regardless of their ownership.

- Directors of foreign-owned banks, therefore, need to meet the local legal and compliance requirements while at the same time acknowledging and conforming to the standards, strategies, and reporting requirements of the parent bank.
- Directors of government-owned banks similarly may have to endure government policy directives and (often unofficial) interference from rulers, ministers, or senior government officials, but these challenges will be in addition to their legal, compliance and reporting obligations as directors.
- Family-owned banks present further challenges, often resulting from the typically large proportion of lending by family-owned banks to related parties, that is, companies or people associated with the owners of the bank. Often such loans are granted on more favorable terms and with more lenient enforcement than a fully commercial transaction would be.

All bank boards need to be vigilant on the issue of related-party transactions (RPTs). RPTs can include not just loans but also contracts and employment. Usually, if boards ensure that such transactions and the relevant relationships are disclosed and transparent, and are subject to the same rigorous scrutiny as other transactions, there should be no problem.

However, if RPTs are agreed on favorable terms and accompanied by less than transparent reporting, they pose potential conflicts of interest for directors (or management), while external stakeholders (regulators, depositors, and shareholders) may gain a misleading understanding of how solid the bank is.

In some economies, inappropriate RPTs have become a significant contributor to bank failures. The resulting loss of investor confidence (and often of their money) leads in turn to reduced overall confidence in the banking system. (See Box 2.)

Even more serious fraudulent activities such as “tunneling” can occur when controlling shareholders or managers strip cash or other assets from a company for their own benefit — in effect stealing from minority shareholders (see the Kabul Bank case in the Introduction).

RPTs can be routine everyday business, especially in banks that are part of a bigger conglomerate or where the government is an important shareholder. However, all directors must remember that their first duty is to act in the bank’s best interest and to ensure that terms of loans or other agreements with related parties, and the expectations of the related party, are consistent with those applying to other business transactions. If for any reason (for example, a directive from a regulator) RPTs are entered into on more favorable terms, at the very least, full disclosure must be made to the board and available to relevant stakeholders.

The main point is that foreign-bank, government, or family ownership does not alter or reduce directors’ duties or obligations but will almost always add to their responsibilities and — if there is a conflict between the two — may make their job even more complex and challenging.

Box 2: Related-Party Lending

Several studies have shown that when banks have a large proportion of RPTs, the margin on loans may be very favorable to the borrower and the risk of default to the bank is much higher (in some extreme cases more than 70 percent of the total) than on loans to unrelated parties.⁶ This level of default can destroy a bank.

A 2007 study examined the relationship between corporate governance and RPTs in Bangladesh. Following the privatization of Bangladesh banks, most bank shares are owned by business people who are consequently on their boards and face the temptation of using the bank's resources for their personal benefit. Although the Bangladesh central bank has extensive regulation regarding RPTs, some banks, in collaboration with their auditors, have made inadequate RPT disclosures.

The study established a relationship between a bank's corporate governance indicators and the number of its RPTs, finding that weak governance creates this opportunity for fraudulent reporting. These findings largely echo the findings of previous studies on the relationship between RPTs and corporate governance.

Source: Mohammad Z. Sharkar, Md Abdus Sobhan, and Shahida Sultana, "Association between Corporate Governance and Related Party Transactions: a Case Study of Banking Sector of Bangladesh" (2007).

Sustainability and ethical issues are influencing boards of banks

A growing number of banks worldwide seek to finance businesses that benefit the environment and society. This trend has been driven by a groundswell of consumers seeking values-based products and services and avoiding companies that are perceived to disregard social or environmental considerations.

In broadening its strategic and operating goals to include social benefit and long-term environmental considerations (in addition to its more conventional financial and operating targets), a bank sets itself high aspirations to achieve. These standards can become catalysts for significant change toward a culture of integrated development and sustainable growth, which may become the core elements of its social responsibility obligations.

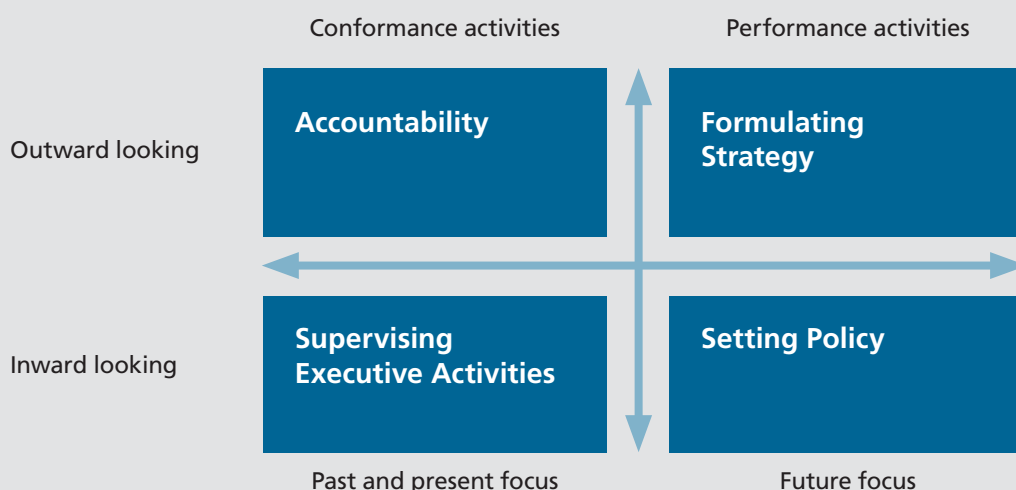
Board members need to be aware of such worldwide trends and debates and the influence on their own decisions, whether these decisions are based on the single performance measure of net profit or the triple bottom line approach of "profit, people, and planet."

The board has several main functions

Robert Tricker describes how the board's responsibilities range from the outward-looking, longer-term focus on strategy through to the inward-looking, mainly short-term focus on supervising the performance of management (see Figure 1).

6. Cited in R. Levine, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence* (Global Corporate Governance Forum, 2003).

Figure 1: Range of Board Responsibilities



Adapted from: R. Tricker, *Corporate Governance: Principles, Policies and Practices* (OUP, 2009).

How this combination of functions guides a board's activities and tasks in the boardroom is explained further by the FICKS™ Governance Framework (see Figure 2).⁷

The first two components, *Future Focus* and *Issues and Risk*, are where the board creates value for the bank by thinking about the future, setting and modifying its direction (while considering the broader environment), identifying strategic opportunities, and discussing key risks to the bank. Ideally, a board spends about 60 percent of its time on these activities, where it can make decisions that influence future results.

Figure 2: FICKS™ Governance Framework

Function			% of Time
F	Future Focus	➔	30%
I	Issues and Risk	➔	30%
C	Compliance	➔	15%
K	KPI Monitoring	➔	15%
S	Skills & Succession	➔	10%

Source: Westlake Governance.

7. FICKS is a registered trademark of Westlake Governance.

The next two, *Compliance* and *KPI Monitoring*, are where the board monitors the bank's legal and regulatory compliance, financial solvency, and management performance. While these are essential functions, they are concerned more with preserving rather than creating value, being largely inward-looking and retrospective, and devoted to monitoring rather than making decisions about the future. The board should usually devote about 30 percent of its time to these areas.

The final 10 percent of a board's time should be devoted to Skills & Succession for the board and senior management, ensuring that the right people with the right skills are in the right structures for the bank to continue creating and preserving value into the future.

3. *The Unique Role of Banks*

Banking is based on trust

Banks play a critical role as trusted financial intermediaries in an economy; they facilitate the movement of funds between sections of the population. Banks create efficiencies for savers and debtors through their market knowledge, transaction efficiency, and ability to enforce contracts between borrowers and lenders. These efficiencies, or financial intermediation, are of great benefit to companies and people in the real economy.

Banks depend on confidence and trust, so even though the business of banking is about taking risks, those risks need to be managed prudently.

Banks operate with a uniquely fragile financial structure

Banks are highly leveraged compared to most other types of business, to generate adequate financial returns, and they are therefore inherently fragile. This leverage increases the risk that a bank may not be able to remain solvent, because a decline in the realizable value of the bank's total assets (mainly loans) will reduce the value of its shareholders' equity by a far higher percentage (and increase the leverage ratio accordingly).

As an example, Figure 3 shows in a simplified form the balance sheet of a bank before and after a drop in asset values:

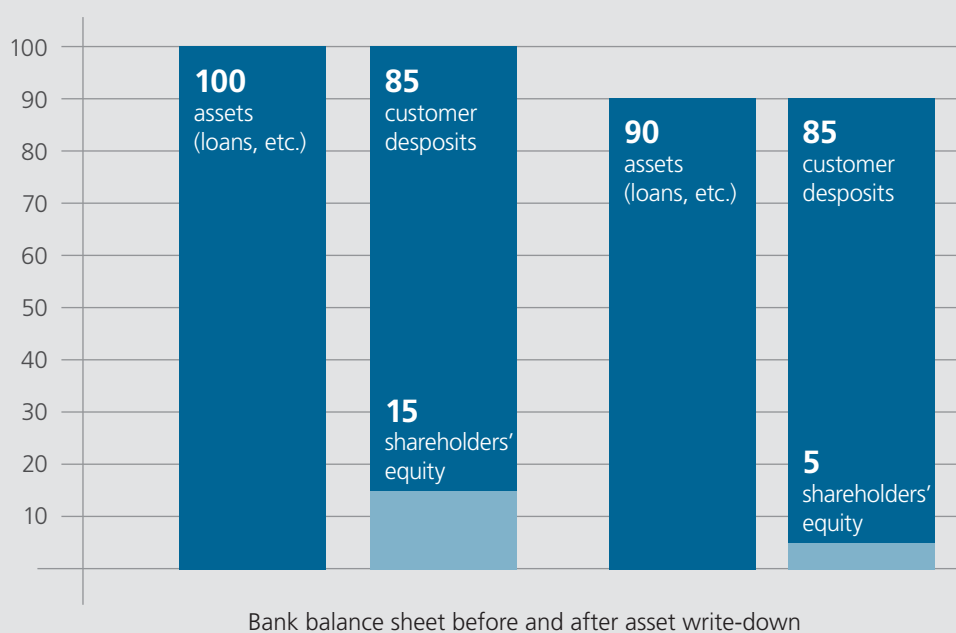
- In the left-hand chart, the bank has assets of \$100, which we will assume are composed entirely of loans to the bank's customers. The bank has shareholders' equity (capital and retained profits) of \$15, resulting in an equity ratio (shareholders' funds to total assets) of 15 percent. The rest of the assets are funded through customer deposits of \$85. This type of balance sheet would be regarded as a well-capitalized bank, compared to traditional bank equity ratios of between 5 percent and 10 percent.

The Asian Commercial Bank (ACB) is one of Vietnam's biggest lenders. In August 2012 its founder, Nguyen Duc Kien, was arrested on fraud charges. At the time, Kien held less than 5% of ACB's stock and played no part in managing the bank (the charges related to three of his investment companies), yet the news was sufficient to cause a run on the bank's branches by anxious customers. The central bank subsequently injected funds into the banking system but the reaction here, and in similar bank crises elsewhere, clearly illustrated how critical it is for a bank to retain the confidence of its depositors — more so, arguably, than in any other industry.

(From Reuters reports, August 2012)

- The right-hand chart shows the effect of a 10 percent reduction in the recoverable value of the bank's assets (loans). During the U.S. subprime crisis, from 2007, the value of many houses fell by at least this amount, and banks were forced to write down the recoverable value of their loans to reflect this drop.
- Realizable assets have been reduced ("impaired") by \$10, to \$90. The \$85 liability of deposits has not dropped (these are debt obligations, so are fixed amounts), so the \$10 reduction in assets therefore reduces shareholders' equity by the same amount, cutting the bank's equity from its original \$15 to \$5 — a two-thirds reduction.
- This drop reduces the equity ratio from 15 percent to 5 percent, or, expressed differently, it increases the bank's leverage (assets expressed as a multiple of shareholders' funds) from 6.67 times, to 20.0 times!
- The value of the bank's assets would need to drop by only a further \$5 for its shareholders' equity to be completely eliminated — that is, its assets no longer exceed its liabilities — at which point the bank becomes insolvent.

Figure 3: The Effect of Balance Sheet Leverage



The other significant structural vulnerability for banks is how they manage their liquidity. This results from the mismatch between duration of its assets and its liabilities: banks traditionally

lend for longer periods (mortgage loans for housing may have a term of 30 years or more) than the terms on which they borrow (many depositors want same-day access to their money).

In extreme cases, these two risks, solvency and liquidity, may compound, and can do so extremely fast. For instance, economic conditions, poor trading performance, or market rumor may reduce public confidence in a bank's strength, leading to depositors demanding to withdraw their deposits. This sudden demand for cash can put pressure on the bank's ability to repay all who are demanding it, because banks usually hold only a small percentage of their total assets in cash. Prudent banks also hold a portfolio of readily tradeable securities that they can liquidate (convert to cash) at any time, to reduce this risk.

However, under some circumstances, a bank may not hold sufficient tradeable securities to satisfy the demand for cash, or may not be able to sell them. Without enough cash, it may then default on legitimate demands from depositors for repayment, leading to a further loss of confidence and more pressure for repayment.

If, further, the bank is forced to sell its trading securities at prices below book value, then the realized loss on sale flows through to a far higher proportionate reduction in its shareholders' equity (because of the high financial leverage), potentially to the point where the value of its total assets is no longer greater than the value of its liabilities. In other words, the bank becomes insolvent.

In most developed economies, every legitimate business and most individuals are connected in some way to at least one bank. As a result, banks have a significantly higher degree of responsibility for managing their assets prudently than other businesses, because the effects of a bank failure can be so widespread.

Banks deal extensively with each other

A bank's liquidity is usually achieved by some combination of having a well-diversified asset base, holding readily marketable liquid (tradeable) assets, managing the maturity profile of its assets and liabilities, and borrowing and lending in the interbank market. Almost uniquely among industries, the trading aspects of a bank's business are conducted with each other in much larger volumes than with end customers. Large volumes of trading between banks increase the depth and liquidity of financial markets by generating constant supply and demand and market-determined prices, but they lead to banks incurring significant risk exposure to each other.

A loss of confidence that leads to a run on a bank's funds not only puts the bank's depositors at risk but also can have the contagion effect of these interlocking risks. If a bank comes under stress, other banks with significant exposure to it may cease doing business with that bank and possibly with other banks that also have significant exposure to it. Then, fearing a run on their own deposits, these banks may decide to conserve cash, investing in short-term readily realizable securities instead of new loans to customers.

If this situation becomes severe enough and spreads across an economy, it may lead to a prolonged and deep downturn in economic activity as companies and individuals are unable to gain access to bank loans for growth, investment, or working capital.

Banks have a duty to their depositors

There is a natural tension between the objectives of depositors, who want to know that their money is safe with the bank, and borrowers, who may be inclined to pursue growth and engage in higher-risk, higher-return activities. It is up to the board as a whole to balance these conflicting incentives.

Central bank regulators are usually more concerned with the soundness of the financial system as a whole than with the strength of any individual bank. However, in many economies, the directors of a bank are required by law to consider the interests of the depositors as well as of the bank itself.

Depositors may also be protected by deposit insurance designed to limit the losses of depositors in the event of a bank failure. For depositors, this can be seen as a good thing, and they may be less inclined to start a run on the bank if a problem is suspected, protecting the bank from a liquidity problem. However, a negative consequence of deposit insurance can be that depositors also stop considering the underlying riskiness of the banks they invest with. This in turn undermines the usual market discipline where a bank has to maintain good lending practices to retain its creditworthiness.

Good banking governance is critical for economies

As we have seen, banks are different from other companies in that their collapse can affect a very wide circle of people and institutions, and undermine the financial system itself, with severe impact on the whole economy. Because of this special position in an economy, banks are usually subject to special laws and regulatory oversight from a country's central bank, in addition to the basic laws governing companies.

Many of the largest global banks were deemed “too big to fail” during the GFC, when they were rescued or taken over by their governments. While there are compelling arguments for protecting the stability of the banking system, it is important to understand that this support undermines normal market disciplines on depositors and bank directors, and can lead to poor banking practices. No government can afford to support every bank forever. The U.S. Federal Reserve “drew a line” under its own exposure to the U.S. banking market when it allowed Lehman Brothers to fail in 2008, after rescuing some of the biggest banks and insurance companies in the world. Many observers see this event as the trigger for the global financial crisis.

One of the controversial elements of many bank rescues was that taxpayers bore the cost of rescuing a bank and its depositors while the directors and management, in many cases, continued in their roles, with seemingly few consequences for their failure. The 2009 Walker Review recommended new structures to ensure that in future taxpayers should not be liable

for the cost of bank failures.⁸ (See Box 3.) All bank directors should be aware of the consequences of their actions or, equally, their failure to act when it is needed.

Box 3: First National Bank of Georgia

The case of First National Bank of Georgia (United States) may be a signal that bank directors and managers will, in future, be held to account for negligent or poor banking practices. In January 2013, U.S. federal regulators filed a case against its non-executive and executive directors for “negligence, gross negligence and breach of fiduciary duties in their operation and management,” leading to the bank’s failure in 2010.

The case seeks damages for the directors’ lack of oversight and unsound bank practices. The case charges all the directors by name, alleging their “gross derogation of their duty to engage in safe and sound banking practices,” and that they failed to implement sufficient corrective measures after repeated early warnings from regulators about exceeding loan-to-value ratio guidelines, and an increase in impaired assets.

Instead, they are alleged to have taken actions that “recklessly and on an uninformed basis caused FNBG to embark on an aggressive growth strategy.” Examiners concluded that poor risk management and “the board’s failure to recognize the risks related to loan concentrations and to implement adequate loan diversification practices” were the primary reasons for the bank’s failure.

Source: Federal Deposit Insurance Corporation, United States, www.fdic.gov.

8. D. Walker (Sir), *Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (HM Treasury, 2009). http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

4. *Governing Risk*

At its core, banking is a relatively uncomplicated business—aggregating deposits and providing loans, while ensuring that borrowers can repay on time and that the bank has cash available for its depositors. In reality, it is a sophisticated, fast-changing, competitive, and highly regulated industry.

Major banking failures in recent years show the renewed need for effective risk governance and adequate internal controls so that banks can anticipate and respond to changing external circumstances and the pace of change in the banking industry.

Bank's control environment rests on three interconnected "legs"

A bank's control environment depends on the effectiveness of three main components, or "legs": Internal control and audit, independent external audit, and central bank regulation and oversight. Failure of any one "leg" can destabilize the entire bank, regardless of how strong the others may be.

Directors of a bank must understand these three components, one internal and two external:

1. Sound management starts with sound internal policies. For any bank, the most important policies that require scrutiny of the internal control systems will usually include (among many others) credit, finance and accounting, and treasury operations (including trading limits, counterparty exposure limits, foreign exchange and interest rate exposures, and information systems and data security.) Inside the bank, a well-resourced and competent control function is essential:
 - The compliance unit ensures that the company acts in line with the legal and regulatory requirements, accepted industry standards, and the company's internal policies and values. Accepted best practice in banks is that a bank's compliance unit operates independently of line management (where the priority is to write new business, possibly at the

Managing risk is very different from managing strategy. [It] focuses on the negative—threats and failures rather than opportunities and successes. It runs exactly counter to the “can do” culture most leadership teams try to foster when implementing strategy. And many leaders have a tendency to discount the future . . . to avoid an uncertain future problem that might occur down the road, on someone else's watch.

(Robert S. Kaplan and Anette Mikes in “Managing Risks: A New Framework,” Harvard Business Review, June 2012)

It's only when the tide goes out that you learn who's been swimming naked.

(Warren Buffett, U.S. investor)

expense of balanced risk analysis or full compliance and documentation). This structure ensures that the board's dual functions of "direction and control"⁹ flow through to the bank's core operations.

- Similarly, a bank's internal audit function should operate independently of line management. The chief internal auditor must have direct access to the external auditor and the independent members of the board — usually through the audit committee. Only in this way can the board take comfort that someone who might identify a control failure can bring it directly to the board's attention. As a further "defence," some boards insist that the removal (or even promotion) of the chief internal auditor should be subject to audit committee approval.

In some banks the audit and compliance functions are combined in one unit, often headed by the chief internal auditor. Emerging good practice is to separate the functions, mainly to provide the compliance function with appropriate status and resources, and to ensure that the activities of the compliance function are subject to "independent review by the internal audit function."¹⁰

2. Externally, the bank needs to engage a trusted and capable independent audit firm that has no conflict of interest with the bank or its senior people (such as a close relationship between the audit firm and another company that a director of the bank may be involved with) that might influence the auditor's objective judgment in preparing an independent audit report.
3. All licensed banks operate under the supervision of their national central bank. The central bank sets requirements the bank must meet in order to continue operating, and these are likely to include some or all of the following:
 - Minimum capital and liquidity ratios, which requirements typically reflect the levels agreed under the Basel Accords (currently "Basel II," migrating to "Basel III").¹¹
 - Limits on transacting with related parties.
 - Conditions relating to board composition, usually including a requirement for some board members to be independent, and sometimes retaining the right to veto new appointments to the board or executive management of the bank.
 - Ownership of the bank (restrictions on shareholding or foreign ownership).

9. The Report of the Committee on the Financial Aspects of Corporate Governance, s.2.5, 1992, chaired by Sir Adrian Cadbury (referred to above), Chapter 2.

10. "Compliance and the compliance function in banks" (Basel Committee on Banking Supervision, 2005). <http://www.bis.org/publ/bcbs113.pdf>.

11. See Annex 1. The Basel Accords, for more.

- The range of (and sometimes territorial limits on) the business in which the bank may be engaged.
- Regular disclosure and reporting requirements.

Directors of banks do not need to be experts in all these areas, but they must understand the role and value of each and they must know how the board interacts with each:

1. Internal board reporting must be sufficient to satisfy directors that the bank has an adequate set of appropriate controls (for which the board may regularly set and review its policies) and that these are being complied with. This requires a reasonable level of financial literacy and at least a general understanding of the types of business the bank engages in and the risks that can arise. One of the identified contributing factors in the bank failures of 2007–2009 was that directors simply did not understand the business and were therefore unable to ask the right questions or to monitor the right signals.
2. The external auditor similarly must be able to operate independently of bank management while necessarily having effective internal working relationships. Besides providing the annual audit report, the auditor can in confidence provide the board's audit committee with valuable insights on the quality and timeliness of internal financial reporting and on how well the bank's overall control system is functioning. In addition, the auditor can discuss with the board any areas of disagreement or concern that may have arisen in preparing the financial accounts (such as the accounting treatment of significant transactions or balance sheet exposures).

It should be axiomatic that a bank's audit committee ought to be composed entirely of financially literate and independent board members. Audit committee members must have the ability to challenge management in relation to the financial reports and should meet regularly with the external auditor, without management being present, so that they can discuss openly any concerns—which may be only subjective observations of early warning signs. All directors have an obligation to understand their bank's financial position and its key risks, and the audit committee is typically considered to have an even higher duty of care and skill in this area.

3. Directors of a bank should have a good understanding of the regulatory environment in which the bank operates. This will extend not only to the specific conditions of the bank's registration but also to any central bank signals (whether direct or implicit) affecting financial markets, the scope or extent of a bank's operations, or a board's appetite for risk.

Many bank boards meet regularly, often informally, with senior members of the central bank. These meetings can be useful occasions for building two-way trust

between institutions and people, which can be valuable if a problem arises, when urgent and frank discussions may be necessary.

The Control Framework has been formalized in recent years

The Basel Accords, referred to above, have brought a globally standardized approach to a bank's control environment. Basel II introduced a variant on the "three-legged" approach with what it describes as the Three Pillars:

1. The *first pillar* defines minimum capital and liquidity requirements for a bank, applying the experiences gained through the 2007–2009 financial crisis when many banks failed. Banks are also required to have an Internal Capital Adequacy Assessment Process (ICAAP), under which they must assess risks other than traditional loan and other exposures, and allocate additional capital against these.
2. The *second pillar* covers the supervisory review process and includes, in addition to financial compliance, the regulator's assessment of a bank's resilience to financial or other shocks and its ability to recover after a significant market disruption.
3. The *third pillar* involves the market discipline, on the assumption that external investors, analysts, and other banks will be able to assess the creditworthiness of a bank if they receive adequate, timely, reliable (audited) information through financial and other regular reporting.

Directors are directly responsible for ensuring that their banks comply fully with these requirements, usually as a condition of their continued banking license from the central bank.

A third wave of Basel is now coming

In response to the GFC, regulators identified weaknesses in the regulatory regime and in their ability to monitor the resilience of the entire banking system rather than just stand-alone banks. Basel III, which is due to be progressively introduced up to 2018 (albeit with varying timetables and degrees of commitment in different countries), sets further standards:

- For qualifying capital instruments (quality of capital);
- For building additional capital buffers when banks are earning strong profits;
- For risks not adequately covered under Basel II: for example, counterparty credit risk; and
- For liquidity management focusing on both short-term and longer-term liquidity resilience.

Each of the three stages of the Basel Accords has raised, and to some extent quantified, the level of care and skill required of directors of banks. The minimum levels are clearly defined,

and directors have a continuing duty to ensure compliance, knowing that failure to do so may have adverse regulatory, market, and reputational consequences.

Banks govern many different types of risk

Banking is a business of risk. Banks make a return for their shareholders by accepting many different types of risk:

- They lend money to customers, incurring credit risk that the borrower may default. One of the fundamental challenges of banking is that its risk is asymmetric: the upside on a loan is limited to the interest receivable (less the cost of its deposits), whereas the downside is the potential loss of the entire principal amount if the customer defaults and there is no (or insufficient) collateral to back the loan. Banks need to strike a balance between the extra reward of a higher yielding loan and the higher probability of loss from that loan.
- They add leverage to their balance sheet — more so than in almost any other industry — to earn an acceptable margin on their total lending.
- They incur liquidity risk by lending to customers for a long term while borrowing from depositors generally for much shorter terms.
- They are exposed to systemic risk or contagion risk because of the high level of exposure of each bank to other banks in the same economy and, in some cases, across national borders.
- An associated risk for all banks is peer pressure — to follow other banks in order to maintain market position. Citigroup's former CEO Charles Prince famously described this tendency in 2007, shortly before the subprime loan crisis triggered major bank defaults: "As long as the music is playing, you've got to get up and dance."
- Besides these inherent risks, most banks also incur several other types of financial risk, such as interest rate risk (between variable and fixed rates) and currency risk (borrowing in one currency and lending in another).
- Nonfinancial risks include the compliance risk associated with the extensive regulation — from domestic market regulators and international prudential standards — that most banks are subject to.

These are all risks that banks take voluntarily as a necessary part of running a successful banking business.

Directors of banks need to understand the business and its risks

In addition to the industry-specific risks of banking, bank directors also need to concern themselves with the full range of internal and external risks that any organization faces. Banks

are subject to more intense public scrutiny than most industries, especially after the financial crisis, so their directors carry a higher degree of risk to their personal reputation than do the directors of companies in lower-profile sectors.

One early-warning signal that directors must monitor is the level of nonperforming loans (NPL), where scheduled interest and principal payments are overdue. A sustained rise in the level of NPL may be a strong warning of further trouble ahead, since it indicates that the bank may struggle to recover principal on its loans and the income from them. A rising trend may indicate a weakening economy or be a result of poor lending judgments by the bank. In Chapter 3, we saw the effect of loan impairment on a bank's balance sheet ratios. Whatever the cause, directors need to act early to protect the bank's capital.

Central to directors' sustained understanding of the business is the skill and courage (or humility) to ask searching questions when they do not understand, or when they need to challenge management thinking or disagree with another director's views. The skill of asking intelligent questions can be threatened in either of two ways:

- If directors do not adequately understand the business, they may not know the questions they need to ask or whether answers are reasonable.
- If a director has considerable status (perhaps resulting from long professional banking experience), he or she may not admit a lack of understanding and therefore may fail to ask the crucial question; or his or her colleagues may be reluctant to challenge, for fear of offending.

The discussion begins with deciding our appetite for risk

Individual directors bring to the boardroom their own personal appetite and tolerances for risk, informed and influenced by their life experiences. Collectively, the board's discussion about risk can be effective only if board members have a sound understanding of the business and the consequences of their decisions. This in turn begins with the board agreeing on the rate of return on capital that the bank wants to achieve, taking into account its current and potential capital resources, and the board's desired risk position in the market, given the reputation it wants to achieve.

As the experience of the GFC has shown, a board needs to understand that risk is a major strategic issue, and not simply a matter of internal compliance, audit and control, or something to be delegated to a committee and otherwise largely ignored. Risk appetite refers to the level of risk (of all types) a bank is willing to seek or accept in order to achieve its growth (and financial) objectives. Risk appetite is accordingly a function of the overall risk-taking capacity and capability a bank has at its disposal, on the one hand, and the target returns on the other, together offering a range of risk-return trade-offs. One way to approach the discussion on risk is to segment it into three main components:¹²

12. R. Kaplan and A. Mikes, *Managing Risks: A New Framework* (Harvard Business Review, June 2012).

First, the risks we accept voluntarily

The first category covers the strategic risks that the bank chooses to accept (or not) to develop a successful business, earning an acceptable return within the risk parameters that the board has defined. Among these is tolerance for credit risk (which may vary depending on the type of lending: for example, to small and medium businesses, personal credit cards, or to state-owned corporations).

The credit risk measurement for a bank is more complicated than simply the face value of loan exposures. Since the Basel I Accord of 1988,¹³ banks have applied a credit “weighting” to their exposures:

- First is the credit weighting that depends on the perceived quality of the customer and the customer’s probability of defaulting (domestic-currency lending to the government being assessed as the lowest relative risk, and lending unsecured to personal or commercial customers as the highest).
- Second is recognition of the likelihood of the bank losing any money if the customer did in fact default: for example, whether the bank may potentially lose its entire exposure (as with a loan on the balance sheet), or whether it is more of a residual risk (as with a foreign exchange settlement or interest rate swap).

The resulting weightings are important, because they determine the size of the “risk-weighted” balance sheet of the bank and in turn the capital requirement and the “risk-adjusted” return on investment needed to satisfy shareholder expectations.

The other risks that the bank willingly accepts include how heavily the balance sheet should be leveraged and how the bank manages its liquidity. Both of these aspects are now subject to stronger regulatory constraints after the pre-GFC experience when the effective leverage of some banks rose by 30 or 40 times, through sophisticated financial structuring, compared to the supposed (“face value”) limit of about 10 to 12.5 times.

The board also needs to make decisions about the strategic market positioning of the bank and the business segments and types of customers it wishes to be associated with. And it needs to be continually scanning the horizon to understand its changing competitive and regulatory landscape.

13. See Annex 1. The Basel Accords, for a discussion of the three Accords.

Second, how we respond to uncontrollable external events

This category includes those risks over whose occurrence the board has no control. These risks include market risk and industry-specific events:

- Changes in the level of interest rates or the “slope” of the interest rate curve over differing maturities;
- Movements in currency exchange rates;
- Changes in the price of various classes of security or commodity (which may underpin securities such as property or gold);
- Systemic failures in the market — such as when wholesale money markets in effect ceased to function during 2008; and
- Regulatory and legal changes — such as the introduction of increased capital and liquidity requirements under Basel II and the prospective Basel III Accords.
- Other changes in this category include those faced by all businesses — such as, for example, natural disasters, changes in the economic or political environment, and long-term demographic shifts.

Banks cannot control whether these events occur. However, research into the origins of the GFC shows that there was sufficient evidence of growing market stress many months ahead of the crisis. As a result, some banks consciously reduced their dependence on wholesale funding and increased their proportion of retail customer deposits, at the expense of some short-term increased interest cost. This experience provides a strong lesson in why boards must focus as much on the future as on the present.

Boards may not be able to control what happens externally, but they must prepare for various events. The recent introduction of “stress testing” of banks is designed to do just this: to test the robustness of individual banks’ balance sheets and liquidity strategies against the possibility of future significant market events.

And third, those risks that we can control and should minimize

Banks face the full range of operational risks of any business, but directors of banks also need to be familiar with several types of operational risk that are either specific to or particularly prevalent in banking.

Credit risk relates to risks that are outside the bank, but which the bank can, to a degree, accept (by lending), mitigate (by taking security cover), transfer (by risk sharing or underwriting), or choose not to accept.

Operating risks arise as a result of how the bank is set up and managed (its systems, processes and people). These risks, unlike credit risk, are not rewarded with a direct commercial return and can pose a significant cost to the business if they do materialize.

Operational risk categories of particular relevance to banking include:

- The integrity of financial and management reporting: regular, accurate management accounting — with a consistent approach to valuation of assets, accounting for gains and losses, and showing the true capital position of the bank — is fundamental to directors being adequately informed.
- Operating systems reliability: banking is increasingly a “real time” business, and transactions need to be recorded and reconciled daily, with constant updating of all key financial and customer balance information and with little or no tolerance for error or lateness.
- Fraud is a risk that banks have always faced, and this can take many forms — forging of loan or security documents, counterfeit money or securities, theft of credit card details, or internal fraud by members of a bank’s own staff: for example, by creating loans to nonexistent customers.
- “Rogue trading” has become a significant risk to even the largest banks: one or more people in a bank identify and exploit control weaknesses in the bank to exceed their delegated trading authority or to engage in unauthorized transactions. (See Box 4.)

Box 4: Rogue Trading

Rogue trading can create significant risk for a bank. In 1995, one rogue trader in Barings Bank generated losses of \$1.3 billion, effectively destroying the bank, while in 2008 Société Générale suffered a €4.9 billion loss through the activities of another trader. More recently has been the “London Whale” case at JP Morgan Chase, with a trading loss estimated in early 2013 to be at least \$6 billion. If a bank has inadequate control procedures (or, worse, collusion between trader and the accounts or settlements department), the risks can grow substantially over time. In these instances, the control failures that allowed the rogue trades over many months were identified only after the event. For some time the bank may actually be the beneficiary of such trades, but it pays the price when the massive unauthorized trading positions turn into a loss.

Source: Various reports.

- “Money laundering” is the use of banks to hide or move illegally gained money, often through a series of complex transactions in rapid succession. Banks are usually the unwitting vehicles for this criminal activity, but they and their directors and officers are increasingly held liable in such cases.
- Physical security of staff, premises, and assets has been a concern for banks since they began operating. Large-scale, sophisticated robberies or armed attacks on bank staff can have a big impact on the individuals affected and the reputation

of the institution, but the sums of money or bullion stolen are generally small in relation to the size of the bank.

- The increasing frequency and sophistication of “cyber fraud” — electronic attacks on a bank or its customers’ accounts over the Internet — is a growing threat to banking globally. (See Box 5.) Attacks can take many forms, for example:
 - Fraudulent e-mails, claiming to be from the bank itself or from a trusted third party, asking customers to reveal confidential information that gives the external party access to money in the customers’ accounts (known as “phishing”);
 - Attempts to breach a bank’s electronic firewalls, sometimes by planting delayed-action worms or viruses in the bank’s software, and providing the electronic equivalent of a tunnel into a bank’s vault;
 - “Distributed denial of service” attacks, under which a bank’s website is swamped with millions of meaningless hits or messages, leading to customers being unable to gain access to the bank and in some cases to the bank being unable to process transactions.

Box 5: Cyber Attack on Financial Institutions in the Czech Republic, 2013

In March 2013, Internet hackers attacked the Czech Republic’s financial sector. The websites of the central bank, the Prague Stock Exchange, and several of the top commercial banks were knocked offline for almost a full business day in an overwhelming wave of digital messages that made the banks’ websites inaccessible to their customers.

Source: Reuters, Financial Times newspaper, and others (March 2013).

This third category of risk covers those where the board can to a considerable degree reduce both “dimensions” of the risk:

- The *likelihood* of a risk occurring, by setting and requiring compliance with sound, comprehensive internal policies and procedures, and setting clear delegations of authority, and
- The *impact* if a risk does occur, by having well-tested backup processes and modern treasury and fraud-detection systems as a part of the bank’s information technology suite.

Asymmetry of information is not an acceptable excuse for poor governance

Non-executive directors will always have less information than management, so they cannot be expected to know every detail of operations or every transaction or product in detail.

However, ignorance of the facts or the law is seldom acceptable as a defense, so boards must require high-quality information and reporting that allows them:

- To understand the “big picture”;
- To be confident the bank is complying with all its regulatory and legal obligations;
- To understand the various options — and their consequences — when they are presented with a decision;
- To have confidence that the bank’s culture and procedures will ensure that all major risks, or events of noncompliance or instances of material fraud, are “escalated” promptly to senior management and the board; and
- To ensure that risk taking is in line with the bank’s approved risk appetite by having in place authorized strategies and limits, and by monitoring adherence to these.

To provide effective oversight of risk, boards must work closely with the bank’s external and internal auditors and ensure that these have full, unrestricted access to the board when they need it.

One of the positive recent developments in boards’ approach to risk has been to view risk increasingly as a strategic issue and not largely a compliance matter.¹⁴ The 2009 Walker Review made specific recommendations on the governance of risk.¹⁵ The most significant recommendation was that boards should establish a risk committee,¹⁶ separate from the audit committee, with responsibility for oversight and advice to the board on:

- “The current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management;
- “The embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside established prescriptive rules and procedures; and
- “The current and prospective macroeconomic and financial environment.”

In smaller, less complex banks a separate board risk committee may be an unjustified additional cost. However, the absence of such a committee does not reduce directors’ responsibilities in any way, and emerging good practice suggests that in such cases “risk” should be a matter for regular review and discussion at board meetings, so that all directors are involved and able to contribute.¹⁷

14. Ivan Choi, Private Sector Opinion 31: *When Do Companies Need a Board-Level Risk Management Committee?* (IFC, 2013) Available at www.gcgf.org/publications.

15. D. Walker (Sir), *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (HM Treasury, 2009).

16. This recommendation is consistent with recent developments in the United States: under the Dodd-Frank Wall Street Reform and Consumer Protection Act, large banks are required to establish a separate risk committee that is not part of any other board committee.

17. Some bank boards (whether or not they have a risk committee) start each board meeting with a broad review of the bank’s strategic risk indicators. This discussion often “frames” the discussion for other items on the agenda.

Boards must approach risk with a strategic, outward, and forward-looking perspective. This is mainly why risk should be separated from the audit function, which largely takes an inward, retrospective view. This separation is now established good practice and reflects the “three lines of defense”:

1. the risk the business assumes and is primarily accountable for,
2. the risk oversight and management function, and
3. the internal audit which seeks to provide independent assurance.

The Walker Report also recommended that banks appoint to the executive team a chief risk officer (CRO), “who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units.” The CRO should also have direct access to the risk committee chair.

Importantly, boards can delegate powers, but they retain the ultimate responsibility for agreeing on a bank’s strategy, for agreeing on its risk appetite, and for ensuring that the main risks are identified and actively managed. Boards can mitigate the risks of noncompliance by setting “the tone at the top”—ensuring that there is a culture of honesty and integrity throughout the bank.

At our company, we’ve made a lot of mistakes. We try to learn from those mistakes. . . then we look for new ways of making mistakes.

(Lloyd Morrison, New Zealand business leader and philanthropist, 1957–2012)

Governance failures in several recent cases (including both Barclays and UBS) led to boards claiming they had no way of being informed of the wrongdoing by the traders or middle management, so they should therefore not be held accountable for the fraudulent actions or large losses suffered. Such a defense generally has not been accepted. Legislators and bank regulators

have deliberately created a framework for oversight and reporting that makes directors of banks personally responsible for compliance.

If, in the end, a director is not satisfied with the information he or she is receiving, or cannot agree with the board’s actions or strategic direction, that director must always be willing to resign from the board. While this alone may not change the direction or decision of the bank, the off-cycle resignation of a director invariably raises attention and is likely to cause questions to be asked.

Banking is an industry centered on risk, and there will always be mistakes; the important thing is to limit their occurrence and impact, and for everyone to learn from them for the future.

5. Board Structures and Directors' Duties

A board is only as good as the people around the table. To enable the board members to govern effectively, with knowledge and wisdom, the board needs to be supported by a range of protocols and structures.

The size of boards varies considerably

The appropriate size of a board depends on many factors, such as ensuring an adequate breadth of skills, experience, and stakeholder perspectives. However, globally the size of boards has decreased over the last few decades. This is a broad generalization and subject to many variables, not least to customary practice in different countries. (See Box 6.)

Increasingly, financial markets are becoming political markets. That requires different skills — skills not all of us have acquired at university; how to properly deal with society, for example, a stakeholder that has immensely grown in importance since the financial crisis.

(Josef Ackermann, McKinsey Quarterly, June 2012)

Box 6: Board Sizes

According to a study conducted in 2012,¹⁸ the average size of boards of banks across all countries is 15.6, ranging from the smallest with four members (a U.S. bank), to 34 (a Russian bank). Similarly, the national average board size also varies, for example, 10.0 in Argentina, 21.3 in Germany, 17.6 in India, and 10.7 in the United States.

Source: Daniel Ferreira, Tom Kirchmeier, and Daniel Metzger, *Boards of Banks* (Paper, London School of Economics, 2012).

A board that is larger than necessary can mean that building consensus becomes very time-consuming, with the practical challenge for the board chair of ensuring that every member can participate fully in the board's discussions and activities.

At the other extreme, if a board is too small it may not have enough diversity of perspective or skill sets among its members. If a board has only three or four members, this may lead to the common danger of “groupthink,” in which members of a board form a collective view that nobody challenges or tests, and which may ignore contrary or uncomfortable new information.

Another influence on the composition of a bank's board can be the degree of control of the shareholder(s) and the regulatory authorities, especially the central bank. In several jurisdictions, the central bank sets rules such as requiring a minimum percentage of the directors to be

18. See Daniel Ferreira, Tom Kirchmeier, and Daniel Metzger, *Boards of Banks* (Paper, London School of Economics, 2012).

independent or retaining a right of veto over board appointments (often referred to as the “fit and proper person test”).

For a complex organization, such as a medium or large bank, a board of between seven and twelve directors is a reasonable guide. A board such as this should permit:

- An appropriate range of skills and experience;
- Sufficient diversity of perspective and views;
- The ability of everyone to be fully engaged in the board’s discussions; and
- A manageable size to facilitate prompt, rational decisions.

Board structures also vary globally

Governance structures vary between countries. The main difference is whether the law requires a single-tier (or unitary) board, or a dual-tier structure.

The single-tier board is a single board of directors to which the CEO is accountable, and he or she may also be a full member of the board. Where the CEO is a member of the board, he or she may be referred to as the managing director (MD). Some of the senior managers may also be appointed as board members, and they and the MD are referred to as “executive directors.” Single-tier boards may consist of:

- Exclusively executive directors;
- A combination of executive directors and non-executive directors, some of whom may be classified as independent directors; or
- Exclusively non-executive directors, some of whom may be independent.¹⁹

In many countries, a director may be the nominee of a controlling shareholder or other key stakeholder, such as the government. Such a director is in a difficult position, because the person who has appointed him or her will often assume that the director will influence the board to act favorably toward that stakeholder. To retain their integrity, and avoid being compromised in this way, nominee directors must ensure that their “sponsors” understand their obligation, once they join a board, to act in the best interests of the bank and not of any individual stakeholder. This tension, especially if unresolved or not understood, can become divisive within the boardroom, and potential directors may consider whether it is better to decline appointment than to find themselves with this conflict of duties. This of course is often easier said than done!

The main argument in favor of the single-tier board structure is its simplicity, and it allows an effective blending of executive and non-executive perspectives. Many experts consider that a “blended board” is the best form for single-tier boards.

19. Please refer to the Glossary for the definition of and difference between executive, non-executive, and independent directors.

The biggest concern about the single-tier structure relates to the role of the executive directors and whether they will genuinely hold the CEO/MD to account. In the extreme case, it may be very difficult for an executive-dominated board to remove the underperforming CEO — it is hard to sack your own boss!

The United Kingdom and the United States, and most British- or American-influenced jurisdictions, operate with single-tier boards. Other countries that operate (solely or predominantly) with the single-tier model include Spain, Cyprus, and Turkey.

The other basic model is the two-tier system, better known as the German model, adopted in many other countries, such as Austria, the Netherlands, and Indonesia. Elsewhere the law allows a choice: for example, France and Bulgaria allow companies to choose either a single- or two-tier board structure, while Italy allows three options, the single- and two-tier models and a traditional, uniquely Italian, governance model.

The two-tier system usually operates through a management board chaired by the CEO and composed entirely of executive members, which is accountable to a supervisory board consisting largely or exclusively of non-executive and independent board members. The CEO may also be a member of the supervisory board but would not usually be its chair.

The roles of the two boards are self-explanatory:

- The *management board* is responsible for managing the operations of the business.
- The *supervisory board* monitors the management board and may have a role in approving major transactions or strategic initiatives.

The main argument against the two-tier model is that it is cumbersome and that members of the supervisory board are too far removed from the business to make a valuable contribution.

The principles of governance remain the same

In many ways, the differences between single-tier and dual-tier board structures appear greater than they actually are:

- The management board (as described in the two-tier model) equates to the CEO's executive or senior management team (in a single-tier model), and
- The supervisory board (two-tier model) is the equivalent of the board of directors (single tier).

Under either the single- or the two-tier governance structure, the principles for governing a bank remain essentially the same: the board's, or supervisory board's, main role is to provide high-level direction, control, and independent oversight of the strategic direction. The management board, or executive team, is responsible for the day-to-day operations of the company.

Some boards consider that the two-tier structure, where the CEO is a member of the supervisory board, strengthens communication between board and management and increases the CEO's accountability to the supervisory board and shareholders. Others consider that it conflicts with the role of the supervisory board to provide objective oversight of management. In practice, the CEO's formal position is less important than the degree to which board members can hold management to account, or whether the CEO can dominate or steer the board, by force of his or her position, personality, or — in some cases — ability to pressure individual board members, especially the board chair.

For simplicity, the single-tier model is used as the basis for discussion in this book. For readers working under a two-tier structure, references to the “board” should be considered as referring to the supervisory board.

Directors may be executives or non-executives

When a company first establishes a board of directors, it is usually composed mainly, if not exclusively, of executive directors — people who work fulltime in the company. In many cases, they may also be its owners. This has obvious advantages, because they understand the business and have a personal interest in its success. However, the disadvantages can pose dangers:

- Self-interest, with little constraint or oversight of decisions;
- A likelihood of similar viewpoints among people who may know each other very well and have worked together over a long period;
- Uncritical acceptance of the CEO's viewpoint, since this person is likely to be the manager of the other board members; and
- Limited external perspective or independent thought.

If the CEO is dominant or owns the company, there are further dangers for executive directors:

- Reluctance to challenge, for fear of jeopardizing their jobs; and
- Failure to ask the “stupid” question, such as *Why are we doing this?* Such questions may make the group uncomfortable by challenging long-held assumptions. In some societies this reluctance can stem from the cultural context: for example, the importance of the family, because directors may fear embarrassing senior family members around the board table.

The next stage in a board's evolution is to appoint one or more non-executive directors. These directors may have some connection to the company, for example, as previous employees, but they add value to the board because they can take a more independent line and may feel they can more easily challenge the CEO since they do not depend on the company for their main salary. However, some non-executive directors may still be connected to the board by their previous association so may not be fully independent in their thinking.

Independent directors can add even more value

The most important evolution for a board is to add non-executive independent directors.²⁰ These are directors who have no other significant relationship with the company, so their only incentive is to act in the company's best interests. These directors may or may not be experienced in banking; if not, they need to gain a good general understanding of the industry. They should also have a level of “emotional intelligence”; that is, the ability to relate to other members of the board and understand their perspectives. Independent directors can add further value through:

- Their objectivity;
- Knowledge of other industries/markets and different networks of valuable contacts or stakeholders;
- The freedom to ask the “stupid” question, especially if they are not banking experts; and
- The ability to challenge current management thinking without fear or bias.

Independent directors should not be so close to the business that they lose perspective; instead, they bring a differing perspective and a different set of disciplines.

Central banks typically want to ensure that these qualities are present on banks' boards. The recent trend of regulators and shareholders of publicly traded companies has been to increase the proportion and influence of independent directors. Stock exchanges in many countries, such as Finland and New Zealand, recommend (or may require) that publicly traded companies have a minimum number or proportion of independent directors. Elsewhere, such as in the United Kingdom and the United States, boards are largely free to choose the proportion of independent or non-executive directors, which has traditionally been quite low.

There is debate about whether banks with more independent directors performed better during the GFC. One study suggests that banks with more independent directors actually fared worse than boards that had more executives.²¹ It concluded that “independent directors may not always have the expertise necessary to oversee complex banking firms.”

Independent directors with no banking background, for example, might not have understood some of the highly complex transactions that banks engaged in, and would be unlikely to know which measures to monitor or the appropriate questions to ask. Some of the biggest U.S. banks that required government bailout had boards on which none of the independent directors had any real financial markets expertise.

However, we must not confuse independence with lack of expertise. A growing body of evidence worldwide indicates the considerable value of having at least some independent directors on a board. An equally valid conclusion from this study could be to reinforce

20. See Annex 2. Defining an Independent Director: International Finance Corporation, for guidelines.

21. See Renée Adams, *Governance and the Financial Crisis* (Working Paper of the European Corporate Governance Institute, April 2009).

the need for all directors to understand their industry—and for regulators to accept that independence without the necessary skill and experience is not sufficient to improve the quality of governance.

All directors must understand their obligations

Bank directors, regardless of their background, have an obligation to ensure that they have a thorough understanding of the banking business and corporate governance.

A common and mistaken assumption is that directors have a duty to act in the best interest of the shareholders. In most jurisdictions this is incorrect; their primary duty is to the *company* itself. Usually, the interests of the company will be naturally aligned with the collective interests of the shareholders—for instance, strategies to increase earnings—but not always. For example, a bank’s shareholders may want increased dividends to give them a better return on their investment, while the directors may consider it in the bank’s best interest to retain and reinvest earnings. Such decisions can sometimes lead to considerable tensions and discontent among shareholders.

Where directors may be expected to act on behalf of all shareholders collectively, they are specifically required not to act in the interests of any single shareholder or shareholding group to the disadvantage of others. While this tension can lead to possibly the single greatest conflict a director may feel around the board table (especially a director appointed by a major shareholder), directors owe their first duty to the bank itself and are answerable to the shareholders only for the way they discharge this duty.

In most countries, this obligation or “first duty” applies regardless of whether the bank is publicly listed on a stock exchange, privately owned, or owned by the government—a fact that major shareholders can have difficulty understanding or accepting. Where a bank is a wholly owned subsidiary of a parent bank or other company, the law may (under some circumstances) permit the directors to act in the best interests of the parent rather than of the bank itself. Directors on the boards of subsidiary banks must be familiar with the legislation that applies in their jurisdiction. (See Box 7.)

Directors may face conflicting pressures

If a conflict of interest arises between a director’s personal interests and duty to the company, he or she must disclose this conflict formally to the rest of the board. In the absence of any specific course of action required by the law or the bank’s constitution, the rest of the board should determine whether the conflict is material and, if so, how best to manage it.

The response may range across any of the following, depending on the degree of conflict (or, more usefully, the degree to which an informed, independent observer might perceive that a conflict existed, commonly referred to as the “newspaper headline test”):

- If the conflict of interest is minor, the board may determine that there is greater value in permitting the conflicted director to participate fully in the matter.

Box 7: Risks of directing in non-transparent, emerging markets

The 2011 takeover of the Bank of Moscow is a cautionary tale for directors. In the biggest banking scandal in modern Russian history, the government of Moscow sold its 46.6 percent stake in the Bank of Moscow (BoM) to state-owned bank VTB in 2011.

After the takeover, VTB claimed to have found dubious loans worth billions of U. S. dollars to businesses related to BoM's senior executives. This led to a Russian federal government bailout of \$400 billion to avoid the potential consequences if the bank failed. The former senior managers at BoM claimed that VTB's takeover was a power grab, without public tender, by Kremlin-backed interests whose accusations provided the excuse for the bailout to cover up problems with VTB's own balance sheet.

The truth may never emerge, but the case remains a warning about institutional deficiencies and poor oversight common to the banking sectors of many emerging markets. Directors must remain alert and do all they reasonably can to ensure that they know what is really going on in their bank.

If a director does not believe he or she is receiving adequate reliable information, resignation must always be an option.

Source: Reuters and other news agencies (2011).

- In a more serious conflict of interest, the board may decide that the conflicted director should abstain from both the relevant discussion and the vote.
- If, however, a director has a continuing or serious conflict of interest that would be perceived to reduce his or her ability to contribute fully to the board, then the director and the board should consider whether resignation from the board is the appropriate action.

In all cases, the existence of the conflict and the board's decision should be reflected in the minutes of the meeting. If conflicts of interest are properly addressed and disclosed in good time, they need not cause embarrassment or difficulty for either the bank or the conflicted board member.

Directors owe a duty of care to the bank

In many countries, courts and regulators are raising the threshold of competence and care that directors are expected to apply to their role. In simple terms, the duty of care requires directors to:

- Take an active and continuing interest in the affairs of their bank;
- Take reasonable steps to understand and remain up-to-date on the financial market sector(s) in which their bank is involved, the key elements of success, and the main risk factors facing the bank; and

- Prepare themselves adequately (as a minimum, by reading and understanding their board papers before the meeting) and attend and participate fully in board meetings and decisions.

They also have a responsibility to keep the bank solvent

Directors have a legal obligation to keep the company solvent and may be held accountable by law if the company fails. Their obligations in the company's best interests include:

- Attracting and retaining good employees, and especially a CEO who has the appropriate skills for the role;
- Minimizing any loss to creditors in the case of insolvency or liquidation; and
- Ensuring that the company considers the stakeholders that are affected by the company's operations.

The strongest defense for directors to avoid being held accountable if their bank fails is for them to demonstrate that they made reasonable inquiries relating to the operation of the bank from people they were entitled to rely on, such as management or the external auditors; that they applied at least a reasonable degree of care and skill to their role; and that they acted in what they believed to be the bank's best interests.

Directors must be able to read financial statements

Directors must ensure that they understand financial information in addition to the written reports. They should require high-quality, timely information, including key balance sheet information, the size and components of the bank's earnings, and the sources and uses of cash needed to show key ratios and trends.

Courts are increasingly requiring each director to form his or her own opinion rather than relying on the opinions of better-informed colleagues or industry experts on the board when reaching a decision.

By ensuring a reasonable level of financial literacy, and by asking questions when they do not understand matters, directors can fulfil their obligation to stay informed on the financial position of the bank they govern.

A board needs the right mix of skills and personalities

Directors should be appointed from a wide range of backgrounds to ensure skills that will deliver breadth of experience and healthy debate to the board. Particular qualities needed in directors include key competencies such as good business judgement, entrepreneurial talent, vision, integrity, character, and common sense, along with strategic, analytical, interaction, and teamworking skills.²²

22. Institute of Directors in New Zealand Inc, *The Four Pillars of Governance Best Practice* (2012).

The board of a bank also needs to include directors with appropriate financial experience and expertise. The Basel Committee identified that the board of a bank needs experience in finance, accounting, lending, bank operations and payment systems, strategic planning, communications, governance, risk management, internal controls, bank regulation, auditing, and compliance. A collective understanding of the financial and economic environments also helps ensure sound governance,²³ while a high level of financial literacy—for example, understanding financial tools such as complex financial derivatives—is needed in at least one board member. (See Table 1.)

Table 1: Skills and Experience for Directors of Banks – Summary

All members should have these:	Some members should have these:
<ol style="list-style-type: none"> 1. Sound business judgment 2. Integrity 3. Strategic thinking 4. Analytical skills 5. Financial literacy 6. Financial industry understanding 7. Appreciation of changes in the bank’s environment 8. Teamwork 9. Courage 10. “Emotional Intelligence” 	<ol style="list-style-type: none"> 1. Credit and lending 2. Treasury products and dealing 3. Bank regulatory processes 4. Bank operations and payment systems 5. Risk management 6. Accounting and taxation 7. Audit and control processes 8. Good governance 9. Chairmanship 10. Senior management experience 11. International experience

Source: Westlake Governance in-house training materials.

Boards should also consider the combination of personalities on the board when appointing directors. The “group dynamic” that results from the personal interactions among individuals can be creative and productive, but it may also be destructive with the wrong mix of people.

Increasingly, banks benefit from recruiting board members not only for their competencies and skills but also for their personal style. This move has been encouraged by Richard Leblanc’s “10 Cs of director behavior,”²⁴ a classification system that identifies five functional and five dysfunctional director types. (See Table 2.)

A well-balanced board will typically include directors whose personal styles are complementary, with every style listed in the “Functional” column below represented in the behavior of the directors.

Typically, a director feels most comfortable in one of these quadrants, but an experienced, capable director can identify dysfunctionality and gaps within the board and move to fill

23. Basel Committee on Banking Supervision, *Principles for enhancing corporate governance* (October 2012).

24. R. Leblanc and J. Gillies, *Inside the Boardroom: How Boards Really Work and the Coming Revolution in Corporate Governance* (Wiley, 2005).

those gaps when needed. It is also quite common for a director to fill one role on one board and a different role on another.

Table 2: Leblanc Personality Types

Director Role	Functional types	Dysfunctional types
Board Chair	<ul style="list-style-type: none"> • “Conductor-Chairs” relate well to directors and management, and have a keen interest in effective governance. 	<ul style="list-style-type: none"> • “Caretaker-Chairs” do not run board meetings effectively and do not have effective working relationships with other directors, the CEO, or the management team.
Director	<ul style="list-style-type: none"> • “Consensus-Builders” act as conciliators, seeking the collective view. • “Challengers” ask the tough questions. • “Change Agents” act as catalysts for bringing about fundamental change. • “Counsellors” have strong persuasive skills. 	<ul style="list-style-type: none"> • “Conformists” are nonperforming, cooperating directors who support the status quo. • “Critics” constantly criticize and complain. • “Controllers” dominate board process through skill, tact, humor, or anger. • “Cheerleaders” are enthusiastic amateurs with little awareness of strategic issues.

Source: R. Leblanc and J. Gillies, *Inside the Boardroom: How Boards Really Work and the Coming Revolution in Corporate Governance* (Wiley, 2005).

Emerging good governance practice is to separate the roles of chair and CEO

Current practice varies significantly between countries: in the United States, the combined role of chair and CEO still dominates much corporate and banking practice. Its advocates argue that the structure enables rapid decision making and clarity of direction, potentially leading to greater returns. The counterargument is that the combined role brings a higher risk of failure, because the concentration of power and absence of constraint make it harder for the board to monitor and counsel the CEO or to ensure good debate and sound decision making.

The situation may be exacerbated if, as often occurs, the chair also controls the board’s appointment process and can “stack” the board with friends or allies. Analysis of banks that performed poorly during 2007–2009 reveals that many of them suffered from weak boards that did not stand up to management.

In the banking sector, managing the bank’s risks is a critical function of the board, and the situation of any one individual having the ability to wield excessive power increases the risk of governance failure and, potentially, bank failure. Pressure globally from regulators, credit rating agencies, significant shareholder groups, and, increasingly, the media is leading to more separation of the two roles.

In general, an independent non-executive chair is now considered the best option for mitigating this risk on a board. In some countries, the central bank requires this separation.

The chair must provide leadership to the board

If the board chair has the board's backing and works well with the CEO, this creates a powerful board. The board chair needs to ensure that all board members:

- Receive appropriate, timely information and prepare adequately for meetings;
- Participate fully in board activities, aim for consensus decisions wherever possible, and accept collective responsibility for board decisions; and
- Receive a comprehensive induction to the bank when they join the board, and regular further professional development while on the board.

Other duties of the board chair are to:

- Coordinate board committees;
- Ensure that board decisions are understood and implemented; and
- Communicate with shareholders and stakeholders on matters requiring board involvement (the CEO is the appropriate spokesperson on operational matters).

The board chair is also responsible for monitoring the board's composition and structure by regularly reviewing its overall size and mix of attributes and skills. Not surprisingly, the time commitment for a board chair can be at least three times that of other non-executive directors.

The chair is the board's link with management

The board chair manages the board's relationship with management by:

- Maintaining links between board and management through a strong working relationship with the CEO;
- Leading the board's process of assessing management performance on issues such as remuneration or underperformance.

Banks that had board chairs with financial expertise generally performed better in the GFC, because they knew the right questions to ask of management.

The working relationship between the board chair and the CEO is arguably the most critical relationship in the entire company. If their relationship is dysfunctional or ineffective, almost inevitably the board's overall relationship with management will also be ineffective. This can become so bad that the board and management lose confidence or trust in one another. In such a case, the only answer may be replacement of either the CEO or the chair.

The chair's role extends beyond the boardroom

An astute CEO will use the board chair as a sounding board for important issues. This is one advantage of having an independent board chair—he or she can take a fresh perspective on

the company and its environment and raise difficult issues where non-independent directors might hesitate.

The board chair can also serve as the point of contact for major shareholders or stakeholders, providing a degree of “cover” that allows the CEO to focus fully on managing the company. The board chair acts as the company’s leader or spokesperson on the big issues only and acts always on behalf of the board.

Board chairs need the moral authority to lead

Best practice corporate governance is for the chair to be elected by the other board members and to remain chair only while he or she retains the confidence of the other members. A board chair appointed from outside the organization (for example, by the government for a state-owned enterprise) has less moral authority to lead, while the rest of the board may feel significantly disempowered from taking action if they lose confidence in the chair.

Board committees can help the board work more efficiently

Board committees are one way of dealing with the increasing demands on boards from globalizing markets, increasingly complex regulation, and rapid changes in a bank’s business environment. Committees are subsets of the full board. The board appoints committee chairs and members and sets terms of reference requiring them to focus on a specific aspect of the board’s business.

Having directors with needed skills and attributes on board committees is a key consideration for board composition. For example, the audit committee should be chaired by someone with in-depth finance and accounting skill (and is usually required also to be independent), while all committee members need sufficient financial skills to allow them to question the bank’s CFO and the external and internal auditors.

Committees usually work faster, more efficiently, and go into greater depth in particular areas than the full board, and they may help limit the time commitment of other board members. They also help free the full board to concentrate its efforts on the big strategic issues facing the bank.

The whole board remains accountable

The board may delegate work to a committee, but it cannot escape the responsibility of that work or of any actions or decisions the committee may take; hence, committees usually agree on recommendations for approval by the whole board.

Because all board members share full responsibility, any board member may participate in meetings of any board committee, unless he or she is properly excluded because of a material conflict of interest or other constraint.

Committees create additional work for directors, managers, and support staff, so the board must plan for their reasonable support. Board committees may need to consult with external experts, but these external third parties should not normally be full members of the committee.

The board of a bank will normally have several committees

All bank boards are usually required to have at least an audit committee. Other committees, depending on the size of the bank, will typically include a separate risk committee, remuneration, nomination, governance, and strategy committees.²⁵

25. See Annex 3. Board Committees, for the terms of reference for four principal board committees.

6. *Effective Board Decision Making*

Of all industries, banking is one of the most heavily regulated. Central banks, competition watchdogs, other government regulators, stock exchanges, and shareholders will all dictate many of the dates when various actions and reports are due.

It's not rules and regulations. It's the way people work together.

(Jeffrey A. Sonnenfeld, "What Makes Great Boards Great,"
Harvard Business Review, September 2002)

The board should spread its main tasks throughout the year

The board needs to update its annual work plan regularly, say quarterly or half-yearly, so that all board members can look ahead and plan their commitments. At a minimum, the following items must be considered at least annually:

- Strategic planning, with at least one review session during the year. Ideally, the board will devote some time at every board meeting to reviewing the strategic direction and the bank's progress;
- Business planning/annual budget discussion and approval;
- Reporting financial and other statutory information at intervals to meet the regulatory requirements;
- The annual meeting of shareholders, which is usually also the time for board elections;
- Monitoring bank performance against the Strategic Plan and Business Plan/annual budget — at least once per quarter;
- Reviewing the performance of the CEO;
- Reviewing board, director, and committee performance, led by the chair and preferably assisted by an outside advisor;
- Reviewing major policies, most commonly on risk, capital adequacy, credit, treasury and liquidity management, employment and remuneration, and health and safety;
- Planning for board and senior management succession, at least annually, to ensure periodic refreshment of board membership.

While certain items need to be fixed in line with the statutory financial reporting cycle, other items are less time-specific. Planning well, months in advance, ensures that the board's workload is spread between meetings to avoid particularly busy times of year.

The frequency of board meetings depends on each bank

How often a board meets should be determined on what is best for the bank, balanced with regular reporting cycles. At times of major change or crisis the board usually needs to meet more often.

Having too few meetings causes problems for the board and can impede management's ability to gain timely board decisions:

- Lack of continuity increases the danger of directors being out of touch with what is happening in the business.
- The “vacuum” left by infrequent board meetings may lead to a “management capture,” when management ends up controlling the business and making all significant decisions, to the extent that the board loses the ability to provide adequate oversight.

Holding too many board meetings is also problematic:

- A considerable amount of senior management time and effort is required to prepare high-quality information for the board. It is vital for directors—especially those who have never held senior executive roles—to appreciate this significant investment of top management time, and the consequent impact on day-to-day business.
- It can lead to excessive operational involvement by the board.

For most banks, either monthly or two-monthly meetings will be best. The longer gap, which may be suitable in times of relative stability, allows management to focus more on the business of the bank. In such circumstances, two-monthly meetings are still close enough for directors to recall previous discussions and remain connected to the business.

However, circumstances vary and the main point is that all boards should make a conscious decision about the frequency of meetings, rather than simply accepting long-established practice.

The order in which the board conducts its business is important

The board chair needs to make sure all board members receive an agenda with the relevant supporting papers early enough for them to prepare thoroughly. In practice, this will mean they receive their briefing material five to seven days before the meeting. If the papers arrive much earlier than this, there is a danger that subsequent events make some information obsolete.

Unless there are exceptional circumstances, experienced directors will not accept papers that are presented at the last minute or, worse still, decisions requested on the basis solely of an oral report from management. This usually implies that the management is either disorganized or does not want the board to look too closely before it makes its decision. Either way, a board that refuses to make an instant decision sends a signal that it is not willing to be captured in such a way.

The agenda should strike a balance between reviews of past performance and forward-looking issues. However, this can be difficult with a standard agenda which generally reviews management and compliance reporting early in the meeting, raising the risk of inadequate time to discuss major issues, emerging trends, or strategic options.

If board members receive and study their briefing pack appropriately in advance, the meeting can focus more on the future than on current operational reporting, with most of its time spent considering the main decisions and strategic issues. (See Box 8.)

Box 8: Example of a Forward-Looking Agenda

A forward-looking agenda might be broadly as follows:

1. Preliminaries:

- Non-executive and independent directors' informal time, without management present, used mainly to agree on the priorities for the meeting and identify any concerns (this applies only to those boards that have a significant number of non-executive directors).
- Update register of directors' interests (to identify any conflicts of interest and agree on actions to address these).
- Action items from last board meeting (making management accountable for timely delivery on commitments made at that meeting).

2. Significant matters for board attention:

- Strategic risk update, emerging trends, significant regulatory developments, other strategic issues and concerns.
- Major decision items (capital expenditure, strategic initiatives, and other matters beyond management's delegated authority).
- Approval of strategic plan, business plan, budgets, financial statements, audit reports, etc.

3. CEO's report:

- Financial and other management/divisional/compliance reports.

4. Approval of the minutes of the previous meeting.

5. Other off-agenda business.

6. Review of the meeting.

Source: Westlake Governance in-house training materials.

The acid test of the value of a board meeting is for the directors to ask themselves at the end whether the bank is better off overall as a result of their having met that day.

The board secretary is a valuable part of governance

The board secretary (also referred to as the company secretary) is most often a member of management in the company but works directly with the board on all matters relating to the board's processes. Board secretaries usually have primary responsibility for making sure the board meets all its legal, regulatory, and financial compliance obligations. The type of person in this role may vary from senior legal counsel, which is common in a complex, highly regulated company such as a bank, to a senior administrator, who ideally combines the attributes of

good organization, clear communication, diplomatic skill to deal with a broad range of senior people, and patience with board members with conflicting calls on their time.

The secretary is responsible for preparing the agenda and distributing the board materials in a timely manner, and for otherwise keeping board members well-informed. During meetings the board secretaries keep a record that is used to produce the minutes. They can also advise the chair on procedural matters. Following the meeting, they produce and distribute the draft minutes, first to the board chair for his or her review and then to the rest of the board. The minutes usually remain in draft form until they are agreed on by the full board at its following meeting.

It is worth observing that the role of the board secretary is widely underappreciated, especially in emerging markets. The person seldom has a high profile in the organization, and many board members will have little involvement with him or her, other than in making administrative arrangements for board meetings. However, the absence of an experienced and capable board secretary can become a major inhibitor to the board's effectiveness.

How directors work together in the boardroom makes all the difference

The way in which the board members collectively do business together is the most important factor in achieving a board that consistently adds value. Core attributes for good interpersonal relationships and consensus building on the board would typically include:

- Trust and respect between board members, and between directors and management, and allowing open debate and discussion. Jan du Plessis, board chair of Rio Tinto plc, one of the world's largest mining companies, has been quoted as saying, "You should never have a situation on a board where directors are afraid to ask a stupid question";²⁶
- Respecting the confidentiality of board information and discussions, and not using such information for personal gain;
- Accepting collective responsibility for board decisions, once taken.

The board chair needs to plan meetings carefully

When the chair is planning a board meeting, there are three main considerations:

- To control the process of the meeting and facilitate constructive discussion and debate by keeping members on topic. This means ensuring that all members have the opportunity to express their views. To reach genuine consensus, the chair needs to facilitate discussion and encourage differing perspectives, and not lead or hinder full debate. The chair is in most situations "the first among equals" and not the "boss" of the other members of the board.

26. Reported in *The Times* newspaper (London, 2010).

- To “set the tone at the top” for the board to operate in an atmosphere of trust, constructive dissent, respect, and confidentiality.
- To make sure that, by the end of the meeting, the CEO is clear about what the board requires and has the authority, resources, and motivation to do the job.

The minutes are more than the legal record of the meeting

Board minutes should normally be about four to six pages long, even for a complex banking agenda. They need to be more than just an outline of the meeting—they should contain a summary of the board’s discussion of issues, allowing an informed reader (such as a newly appointed director) to understand the rationale behind a decision. They also show members key action items that they are accountable for. However, the minutes should not grow to the point of resembling a transcript of every comment.

All board members should be aware that, increasingly, courts place a high value on board minutes as the official legal record, and they will usually regard the board as a single collective decision-making unit. Whatever a board decides at a meeting, all board members—whether present or not at the meeting—may be held responsible for that decision.

Preparing good board papers is hard work

Board papers should generally be focused, forward-looking, and action-orientated. Each substantive board paper should typically be not more than four to eight pages, with any further detail provided in annexes.

A good board paper should normally include:

1. The purpose of the proposal;
2. The decision or further action that the board is being asked for;
3. A brief description of the background, including what the board has already done in relation to the issue;
4. What led to the proposal and how it fits with the company’s strategy;
5. A balanced discussion of the options examined (including “do nothing”), and reasons why the writer (and CEO) consider this recommendation as the best one. This section should normally include a statement of the financial impact of the recommendations and other consequences;
6. Risk analysis and identification, and how to mitigate these risks to an acceptable level; and
7. A recommendation, which should include approving the funding or agreeing to a strategy for implementation.

Annexes support a proposal where necessary, complete with an options analysis; however, the main paper should stand alone without these.

Those who prepare board papers must be aware of their intended audience. If the board has independent directors, some may not have experience or deep knowledge of the industry, so the language must be understandable to nonindustry specialists, explaining technical terms and acronyms.

New board members must receive a proper briefing

While most boards provide a general induction for new members, it is vitally important to ensure that they are fully briefed, so the rest of board is not put at risk by their ignorance.

As noted earlier, banking is a simple concept but a complex industry in practice. One of the emerging concerns in reviews of the bank failures of 2007–2009 has been how little some non-executive board members understood of what was happening in global financial markets, or how quickly the risks affecting their own bank were changing.

The board chair is responsible for ensuring that there is a relevant and comprehensive induction process. Each new director should typically meet with:

- The board chair, to understand the board's functions and important current issues;
- Other directors, including committee chairs, to start building complementary ways of working with them;
- The CEO, for briefing on the business, the strategy, the bank's key people, its external relationships, and the CEO's relationship with the board;
- The top management team, including the chief financial officer, internal auditor, and external auditor. An important component of these briefings should be to give the new director an outline of the regulatory requirements for the bank and any specific obligations of individual directors; and
- The manager of at least one operating branch, so the director can see how the bank works in practice.

The induction helps the new director understand the big issues the bank faces, how the bank and the board work, what is unique about the business, and what are its main vulnerabilities.

Induction does not stop after the director's first meeting

Beyond their induction, directors need to stay current with products and changes in the market and how they affect the company. Bank directors need to ensure that their professional governance skills and their understanding of the bank and financial markets sector remain sharp, especially in a fast-changing market.

Regular meetings with senior management during or at the end of board meetings are valuable for boards. The directors need to be briefed regularly on a wide range of matters: for example, the increasing complexity of bank capital structures, local and international regulatory environments, fraud and money laundering, the growing incidence of cyber crime, and other evolving risks for the business.

A board must be able to grow with the business. Many professional industry bodies provide training specifically for directors, and boards should plan for their members to attend such programs. This includes professional development training, upgrading of governance skills, and ensuring that they understand banking strategy, local and international banking regulatory structures, and the latest thinking on risk.

IFC Global Corporate Governance Forum has developed a comprehensive corporate governance training program, with a module specifically developed for governing banks. To spread this training as widely as possible, IFC regional and country offices work with local directors' institutes to introduce various director training programs. Directors are encouraged to discuss these and other training opportunities with their local director training organization.

Directors have a limited tenure

Many companies set maximum board terms at three or six years. However, it is likely to take new directors at least two years to understand a complex business in-depth, especially if they have not been involved with the industry or the company before.

This is especially the case with non-executive directors, because they are involved with the bank only a few times a month. It is natural that their ability to add value takes longer to emerge.

A non-executive director is likely to add his or her greatest value after being on the board for three years or more, so retiring them too early is counterproductive. On the other hand, if a director is failing to deliver value, or does not take a full part in the board's deliberations, then that director should not expect renewal of his or her term after the first period of appointment. It is good practice to review a director's position every three years.

An effective director should be able to add value, and remain committed to doing so, for between about eight and twelve years. However, after about nine or ten years, it may be difficult for the director to remain genuinely independent and not become complacent. Many stock exchanges regard this period as the longest that any director may be regarded as independent.

Directors of banks must be paid adequately, but not excessively

Paying directors a fee per meeting is not good practice, as it can lead directors to think they need to work only at meetings, and it may encourage them to hold more meetings than are necessary.

Setting an annual fee for directors is better practice. It recognizes that the director's responsibility continues outside the boardroom, and provides an incentive to do the job well rather than simply to hold meetings.

To set the level of directors' fees, it is important to find an appropriate balance between providing a fair return for the role, and ensuring that it is not so high that a non-executive director is totally reliant on it. A director must always feel able to resign from the board if necessary.

Banks face growing complexity and increasing regulatory requirements in a dynamic industry. If they are to attract capable, committed independent members to their boards, and retain them, they will need to ensure that they reward them adequately.

Assuming that a board should usually comprise people of a caliber similar to that of the CEO, one way to calculate an appropriate fee is to take the CEO's base remuneration (exclusive of performance bonus or incentive pay) and multiply it by the approximate proportion of their time that directors are expected to commit to the role. A CEO's base salary usually takes account of all the market factors influencing the role—industry, complexity, size, relativities—so this becomes a relatively objective benchmark for setting directors' fees.

In most cases, the annual fee should be the same for all non-executive directors, with the main exceptions being:

- Fees for the board chair, which should be two or three times the standard directors' fees, to recognize the significantly greater workload;
- Fees for the board's deputy chair and chairs of committees, typically set at about a 25 percent premium to the base directors' fees; and
- Fees for membership of a board committee, typically a premium of about 10 percent.

Share-related remuneration for directors is often seen as a suitable way to align the interests of the directors with those of the shareholders, but this should normally amount to no more than one-third or one-half of the total fee so the size of the potential total remuneration does not compromise directors' independence.

Boards should evaluate their own performance

It is good governance practice for a board to review its own performance and that of its individual members and the chair on a regular cycle. The board as a whole needs to be evaluated on whether it makes good decisions, asks adequate questions of the CEO, remains accountable, and functions well as a team.

The CEO²⁷ should normally contribute to the evaluation process, because the primary purpose of the board is to help the CEO do his or her job better. Any board that does not understand this duty—to assist the CEO—is usually failing in its role.

Each director's contribution, separate from the board as a whole, also needs to be evaluated. The key question is whether the director is the right person to continue adding value to the company in the future and, if so, whether he or she needs to adjust his or her behavior or would benefit from further professional development. These individual reviews are usually confidential between the board chair and the director, although confidential input from other members of the board and the CEO is very helpful. Board committees may also be reviewed for their effectiveness and the tenure of their members.

The board chair can lead the performance reviews, or the board may commission an external advisor. Using an advisor is usually preferable.

The incidence of board evaluations is growing internationally but is still resisted in many countries and cultures. Regulators and credit rating agencies regard regular evaluation as good practice: evaluation should be a constructive experience, because it is designed to help the board perform better rather than only to find what a board, or individual directors, may be failing to do.

The results of such evaluations should remain confidential so they cannot be used by shareholders or others as a tool for attacking the board or individual members. A company with transparent board practices may report that it has completed such evaluations and that the board as a whole has made certain changes as a result, but it would not normally make public the findings about individual directors.

Boards must plan for the future

Succession planning is a critical function of a board. Boards need to be aware of anticipated vacancies due to term limits and the plans of individual directors for retirement. They also need to plan effectively for succession in the membership of board committees, since these frequently have members with specialized skills or experience that other current members of the board may not possess.

A board must always have a plan for CEO succession in case, for whatever reason, the current CEO is no longer available. The planning will vary depending on whether the board is likely to prefer an internal or external appointment. If it is assessed that continuing in the current general direction is best for the business, the board may have a preference for an internal, known candidate to ensure a degree of continuity. However, if the business needs a significant change of direction, an external appointment may be best to bring a fresh approach. (See Box 9.)

27. This assumes that the CEO is not also the board chair—a separation of functions that is increasingly regarded as good practice.

Box 9: Replacement of Citigroup's CEO

One controversial CEO transition was the sudden replacement of Vikram Pandit at the head of Citigroup Inc. in late 2012. The independent members of the board, led by the independent chair, Michael O'Neill, had evidently planned this move over several months and even had their chosen successor, Michael Corbat, ready to step in when the pressure was put on Vikram Pandit to resign.

While this action received much adverse publicity, it demonstrates well the value of splitting the roles of the board chair and CEO. If one person had held both roles, the process would have become considerably more complicated and almost inevitably would have led to a split board—at least for a period.

Source: New York Times and Citigroup public releases (October 2012).

The succession of the board chair is the most critical succession decision after that of the CEO. It is usually poor practice for a retiring CEO to become board chair upon retirement, yet this is a relatively common “progression” in many countries. A former CEO who becomes the chair will probably support continuation of existing strategies rather than accept fresh proposals from the new CEO, especially if these differ significantly from the previous direction. Similarly, when the board chair steps down, the good practice is for him or her to leave the board so that the new chair has a fresh start.

Bank supervisors, such as central banks, often take a close interest in board leadership and require that they approve the appointment of all senior executives and directors to their positions.

The board needs to balance retention of talent with introducing fresh blood

Boards in an industry such as banking, where the environment changes rapidly, must continually assess and refresh the skill sets and interpersonal “chemistry” around the table to meet the new challenges. Identifying new directors for appointment is usually the responsibility of the board's nominations committee.

Legally, shareholders are usually required to ratify a director's appointment, but in practice the board will typically control the process, except in cases where the bank is owned by a dominant or sole shareholder, who is likely to appoint directors of his or her choice. A poor but common practice is for boards to appoint mainly people they are already familiar or friendly with. This is not usually in the best interests of any bank and can easily perpetuate existing poor strategies or fixed attitudes. The appointment of a new board member should have as much rigor as the appointment of a new CEO.²⁸

28. See Annex 3.4. The Nominations Committee, for the key steps in selecting a director.

7. Conclusion

Banks play a unique role in modern society, and almost everybody and every business in a developed economy has a connection with at least one bank. As a result, recessions brought on by failures in the banking system are typically deeper and last longer than “normal” business cycle recessions.²⁹

The biggest lesson from the GFC is that we do not want another. The world is still feeling its impact and will do so for the rest of this decade. Among the causes of the GFC were:

- Failures of governance and leadership;
- Director self-interest; and
- Directors’ ignorance or abrogation of their duties.

One of the biggest issues for banks as a result of the GFC is that they have lost much of the trust that is so important for a vibrant, competitive, sound banking system. Not surprisingly, politicians, regulators, investors, and the public now demand higher standards of governance—especially in banks—than previously. Directors must accept this when they take on the responsibility of joining the board of a bank. They must understand that one of their biggest tasks is to rebuild trust from the public.

If you have learned one thing from this book, I hope it is that the next time someone says to you, “The rules have changed; this time it’s different,” you don’t believe it. The rules and principles do not change.

Those who cannot remember the past
are condemned to repeat it.

(George Santayana, Spanish-American
philosopher, 1856–1952)

29. C. M. Reinhart and K. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009).

8. *Postscript*

Why would anyone do this?

If you've read this far, and have understood the many obligations and heavy responsibilities you will have as a director of a bank, you may ask yourself why anybody would want the risk of taking on the job. The reality is that a board position with a bank can offer the challenge and satisfaction of playing a part in building something of real benefit to an economy.

Kiwibank is a New Zealand-owned bank established in 2002. In late 2007, when it had reached about 5 percent market share, the bank's treasurer advised the board that he expected international capital and wholesale markets to become significantly more difficult over the following 18 months—with the cost of borrowing rising and the possibility of difficulties for smaller, lesser known banks such as Kiwibank. He recommended that the bank minimize its wholesale funding and build a liquidity buffer of longer-term retail deposits—although this would be at higher interest than then-current wholesale rates and would therefore reduce the bank's forecast profit.

The board debated the tradeoff between earnings and future liquidity, but accepted the treasurer's advice. When the force of the GFC hit in September 2008, Kiwibank was the only bank in New Zealand with significant surplus liquidity. It entered a major growth phase, providing more than 50 percent of all new home lending during the next six months and almost doubling its balance sheet in the following two years.

This decision may not demonstrate momentous foresight or skill on behalf of the board, but more the wisdom of accepting good advice. However, that single decision was one of the most momentous in establishing Kiwibank as a significant competitor against the main banks, all of them overseas-owned—a position that many commentators had been skeptical of this young bank ever achieving.

For the members of the board, it was a decisive moment of collective decision making (whose significance none of them appreciated at the time)—a decision that only the directors could make, and from which they will always be able to gain professional satisfaction.

Annex 1. The Basel Accords

The Basel Accords are a set of agreements formulated by the Basel Committee on Banking Supervision. They aim to:

- Increase transparency;
- Improve the quality of bank supervision; and
- Strengthen international banking systems worldwide.

The accords arose originally from concerns among banks that operated in jurisdictions with a mature regulatory framework about the risks to the banking system when operating in, or transacting with banks based in, less regulated environments than their own.

Besides setting international standards for capital adequacy, the Basel Committee also introduced with Basel II the concept of the Three Pillars of bank oversight:

- Minimum capital requirements (Pillar 1);
- Supervisory review process (Pillar 2); and
- Market discipline (Pillar 3).

The Basel Committee's recommendations are not binding, but central banks in most developed economies have largely adopted the Committee's recommendations, up to Basel II, and are implementing Basel III at varying rates.

- I. The first Basel accord was introduced in 1988. It focused on the capital adequacy of financial institutions.
- II. Basel II, which replaced the first Basel accord, was introduced in 2004 to keep pace with the increased sophistication of banks' operations and risk management. Its aim was to align minimum capital more closely with a bank's real risk profile.
- III. Basel III has effectively superseded Basel II, and is being implemented from 2013. It has been developed in response to the deficiencies in financial regulation revealed by the GFC 2007–2009. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and balance sheet leverage. These reforms target microprudential (bank-level) regulation and macroprudential (systemwide) risks to provide greater resilience in case of crisis. (See Table 3.)

Table 3: Basel Accord Pillars

Basel Accord	Pillar 1 Minimum Capital Requirements	Pillar 2 Supervisory Review	Pillar 3 Market Discipline
Basel I (1988)	Only credit risk dealt with	(Not dealt with)	(Not dealt with)
Basel II (2004)	Minimum capital requirements	Supervisory review process	Disclosure & market discipline
Basel III (2013–)	Enhanced minimum capital & liquidity requirements	Enhanced supervisory review process for risk management & capital planning	Enhanced risk disclosure & market discipline

Annex 2. Defining an Independent Director

(International Finance Corporation guidelines)

www.ifc.org/corporategovernance

Having independent directors on a board means the presence of directors who can exercise their judgment for the exclusive benefit of the company without any actual or perceived conflict of interest. An independent director fulfils these criteria:

1. Has not been employed by the company or its related parties in the past five years;
2. Is not affiliated with a company that is an advisor or consultant to the company or its related parties;
3. Is not affiliated with a significant customer or supplier of the company or its related parties;
4. Has no personal service contracts with the company, its related parties, or its senior management;
5. Is not affiliated with a nonprofit organization that receives significant funding from the company or its related parties;
6. Is not employed as an executive of another company where any of the company's executives serve on the company's board of directors;
7. Is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the company or its related parties as an executive officer;
8. Is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the company or a related party; or
9. Is not a controlling person of the company (or member of a group of individuals and/or entities that collectively exercise control over the company) or such person's relation by blood or marriage, or heir, legatee, or successor of any such relation, or the executor, administrator, or personal representative of anyone described as above who is deceased or legally incompetent.³⁰

30. See Daniel Ferreira, Tom Kirchmeier, and Daniel Metzger, *Boards of Banks* (Paper, London School of Economics, 2012).

Annex 3. Board Committees

3.1 The Audit Committee

A bank's audit committee plays a key role in financial control and reporting. In helping protect the bank's assets, it serves the interests of the bank, its shareholders, investors, depositors, regulators, and other stakeholders.

The audit committee has a number of main functions:

- It approves, or recommends the approval of, the appointment of external auditors and oversees their relationship with the bank by:
 - Meeting with them regularly;
 - Checking on their relationship with management;
 - Discussing any emerging problems; and
 - Assuring themselves of the auditors' continued objectivity and independence.³¹
- It reviews and agrees on the audit plans, and execution, for the coming year.
- It seeks advice on the latest developments internationally in accounting and auditing and, where relevant, reports these to the board.
- It reviews financial statements, procedures, and systems of internal control over financial reporting, focusing particularly on:
 - Changes in accounting practices;
 - Significant adjustments resulting from the audit;
 - Compliance with accounting standards; and
 - Satisfying the committee that what is being presented gives a true and fair picture of the bank's position and performance.
- It monitors the effectiveness of, and receives regular reports from, internal audit, alerting the CEO and board to anything of importance.
- It reviews the control environment, including
 - The system of control to reduce the opportunity for fraud;
 - The relevant management reports;

31. In some countries, the auditors are accountable, and report directly to, the general meeting of shareholders rather than strictly to the board. However, in practice, the board will always have closer contact with the auditor than the shareholders will, and must maintain a close working relationship.

- The information required by regulatory agencies; and
 - The bank's system of risk analysis and controls.
- It ensures that management has introduced and maintained a sound financial reporting system that generates accurate, reliable, and timely information.
 - It reviews arrangements for compliance with the rules and observations of regulators, monitors the board's response, reports significant deficiencies to the board, and receives reports on the operation of the company's "whistle-blower" arrangements.

The CEO, CFO, CRO, and the internal auditor and other executives may be invited to attend parts of the audit committee's meetings. Depending on the law and practice in different countries, the external auditors are appointed directly by the board or by the shareholders on the board's recommendation. The auditors, as a rule, are accountable directly to the shareholders, who rely on their independent opinion about the integrity and fair presentation of the bank's annual accounts. In practice, the auditors deal extensively with management during the year and report regularly to the board.

An audit committee, usually of three to five members, is appointed by the board, and, if possible, all members of the audit committee are independent, non-executive directors. All members must be financially literate, and at least one should have in-depth experience and understanding of financial reporting, tax issues, and accounting standards.

The board usually appoints the chair of the audit committee, who must be independent and willing to allocate significant time to the role. (In a moderately complex bank, it is normal that the audit committee chair will devote as much time to this role as to his or her normal director's duties.) In addition to preparing and chairing committee meetings, he or she will also have dealings with internal and external auditors and the CFO and CRO, and possibly also the head of credit and the bank's treasurer.

A bank's audit committees will usually meet about four times a year, at times likely to coincide with the board receiving and publishing quarterly financial statements. They should also meet twice a year with:

- The external auditors, without management present; and
- Management, without the external auditors present.

3.2 The Risk Committee

The risk committee advises the board on matters that include:

- Setting the board's risk appetite;
- The use and appropriate levels of risks limits;
- The bank's risk framework;

- Management’s capabilities with regard to risk management; and
- The bank’s risk management policies and procedures.

The risk committee also oversees the bank’s interaction with other stakeholders as it relates to risk: for example, reviewing the reports on risk governance prepared by management. The committee should receive briefings on significant reputational risk matters and on management’s proposed responses or preemptive actions.

The risk committee’s work can significantly enhance subsequent board discussion of risk and also the risk implications of matters such as remuneration, succession planning, strategic initiatives, external developments, and the board director nomination process.

Modern risk committees will have the skills to address all categories of risk:

- Internal, controllable risks (traditionally addressed by such committees);
- External risks, over whose occurrence the bank has no control (such as changes of government, market downturns, natural disasters); and
- Those risks that the bank chooses to accept in pursuit of its strategic goals.

The risk committee is best composed solely of non-executive directors, particularly those with an industry background in finance and banking, although it can be helpful for at least one member to have an entirely different professional background in order to challenge and ask “new” questions. The CEO, CRO and CFO, head of credit, and the bank’s treasurer may also be invited to attend committees meetings.

For a risk committee to function effectively, it must view risk as a strategic issue, and not merely about compliance and financial risk.

3.3 The Remuneration Committee

The remuneration committee considers matters relating to board and executive remuneration. It approves changes to incentive and benefits plans applicable to senior managers and may be involved with remuneration decisions for the entire company.

To avoid any potential conflict of interest, a remuneration committee should be composed mainly of independent, non-executive directors, and will usually be chaired by the board’s independent chair (if there is one) or the lead independent director.

The remuneration committee:

- May oversee the bank’s overall remuneration policies and practices;
- Considers the CEO’s and other executive directors’ remuneration against a background of the bank’s remuneration policy for its entire senior staff, and against external benchmarks or surveys;

- Recommends to the board appropriate levels of remuneration for all board positions (chair, deputy, committee chairs, and other non-executive directors). Such recommendations usually need the approval of shareholders, who may vote a total amount for board remuneration, based on the sum of the individual components;
- Examines how incentive and bonus plans are calculated, and tests the figures; and
- Examines compensation arrangements for loss of office, especially when caused by poor performance.

3.4 The Nominations Committee

The nominations committee considers matters relating to corporate governance, including the composition of the board, the appointment of new directors, and the ongoing professional training of board members.

The nominations committee:

- Reviews strategic human resource decisions and succession plans for the board chair and other key board and executive positions;
- Reviews corporate governance structures and processes; and
- Oversees the annual performance evaluation of the board, its committees, and the individual directors, including the board chair. (It is good practice, although less common, also to review the performance of board committees and committee chairs and members, and to review the terms of reference for each committee, to ensure that the committee remains “fit for purpose.”)

Members who can provide leadership to the bank and are unafraid to debate with executives are key to the composition of this committee. Seeking to have directors who are independent helps achieve this.

Director selection and appointment using best practices may go as follows:

1. Identify a board capability gap — the knowledge, competencies, expertise, and any key stakeholder links that the board lacks.
2. Develop a person specification — the knowledge, skills, and personal attributes that a director would need to close this gap.
3. Develop a search plan — this may involve the use of search consultants, and the position may be advertised.
4. Get to know the preferred candidate(s) — the nominations committee will need to interview candidates to assess their competence (“can they do it?”) and

their commitment to the role (“will they do it?”), and to be reassured that their personal style is consistent with that of the rest of the board (“will they fit?”).

5. Terms and conditions will be discussed before an offer is presented.
6. Check preferred candidates’ references, with particular focus on anything that is not clear from the interview or may be particularly sensitive or important.
7. Identify the best-qualified candidate(s) and recommend their election to the board. In many countries, boards may appoint new directors to hold office until the next annual general meeting of shareholders, when they are nominated for re-appointment. Elsewhere, all director appointments must be made by the shareholders, but still often on the recommendation of the board.

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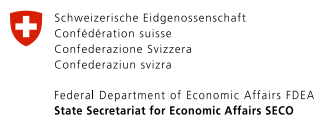
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