

**BANKING GOVERNANCE AND REGULATION
From Real Assurance Risk Management
EXECUTIVE SUMMARY**

The banking system failed spectacularly in 2008. The IMF estimates global banking losses at around \$5trn. It is hard to see this other than as a failure of control by both boards of directors and banking supervisors. Banking executives world wide have operated with insufficient control and this, we believe is the root cause of the financial crisis.

We suggest below some fundamental restructuring of the governance of banks which we believe comprise the only prescription likely to work to prevent a repetition. They will be hard to achieve requiring a fundamental rethink of some very long established, generally accepted practice, however, we believe that our recommendations:

- Have negligible cost either to the taxpayer or the industry;
- Are neutral on executive remuneration;
- Would require no lengthy new regulations nor a significant increase in numbers of banking supervisors;
- Satisfy the public interest in the control of banks as critical elements of the economy.

The other key point to be made by way of introduction is that unfortunately we have two separate reviews going on into the banking system: the corporate governance review being carried out by Sir David Walker, and the Turner review of banking regulation by Lord Turner, Chairman of the FSA.

Having two separate reviews is in our view a mistake since there is the need for a joint consideration of governance and regulation else there is a danger that key aspects may be lost. Our prescriptions for the banking system require integration of the two aspects since solvency assessment (i.e. calculation of capital adequacy) is a key role of the board which is where the overlap of governance and capital regulation occurs.

The basic issue is that banks are overwhelmingly joint stock companies with unitary boards of directors. They are regulated by company law, the governance code and banking regulations. However, the first two elements are aimed exclusively at strengthening accountability of boards to shareholders. This model of governance has operated more or less unchanged for three and a half centuries and we believe it is inappropriate for 21st century banking institutions.

The reasons are simple to understand. First, the true, beneficial owners, of UK companies at least, are overwhelmingly collective investors in managed schemes managed by institutions. Majority beneficial ownership of companies, certainly FTSE 250 companies, are thus the pensioners, ISA holders, insurance policyholders and so on. They are the true risk capital owners who have lost out in the crisis. Governance is supposed to be about ensuring the managers of companies (ie the executive) act in the interests of the owners. But the accountability chain from banking decision makers to the bank's owners is extremely stretched. The accountability chain goes from executive to board, from board to fund manager, from fund manager to trustee and from trustee nowhere since pensioners and unit holders have no practical direct influence there. There is thus no effective accountability from the managers of companies to the beneficial owners. In that sense, governance as we know it does not work.

Second, looking at a unitary board in particular, there is great ambiguity in its supervisory role over the executive. Probably a majority of non-executives would not see that as the primary role and reject any sort of "policeman" image. The other roles of the board include an advisory one bringing in outside thinking to help strategy formulation and a decision making role, both of which conflict with a supervisory role.

In any case, the supervisory role would be extremely difficult to fulfil with the current structure. In the first place non-executives of banks, are in the main, not professional bankers, still less risk managers and there is bound to be a significant knowledge gap, especially in the technical areas that may prove to be of highest risk. In addition non-executives are part time and are expected to grasp the nub of important issues from a mass of papers with little time to do it. Also except on rare occasions when the board seeks outside professional help directly, the board is entirely dependent on information provided by the executive. Finally, the executive itself may comprise 30-40% of the membership of the board. All of these things make fulfilling an effective supervisory role all but impossible for unitary boards. Yet we believe there is a widespread public expectation that this is what boards are, or should be doing.

The conclusion is that unitary boards as currently constituted are not able to exercise effective supervision and control over their executives.

A case in point is the bank's assessment of capital, which for a bank is equivalent to a quantified assessment of the bank's risks. Under the current arrangements, the calculation is carried out by executive management then reviewed by the board under a process called the individual capital adequacy assessment process. A lot of guidance on how this should be done is provided in the rules. However, as we already noted, it is difficult to see how the non executive element of the board could apply the required due diligence, especially for large, multinational banks. The risk reports for the major banks, as published in annual reports, often run to a hundred pages or more of detail, but even then, key elements of detail are not disclosed such as the valuation methodologies for assets and so on. That means there is a large quantity of important information and calculation which lies behind the capital assessment, much of it, for large banks, based on complex models and many assumptions which may not be at all transparent to the untrained person. In practical terms, the board is almost completely reliant on the executive's self assessment. There are of course checks and balances such as independent risk management and internal audit, but ultimately it is an executive responsibility to prepare and sign off the solvency assessment for presentation to the board.

Third, banks use 20-50 times more of other people's money than shareholders'. This is the leverage ratio. Yet banking boards have no duty of care, nor accountability to depositors or other lenders – their relationship is purely a debtor/creditor one and there is no legal position of trust created between a bank and a depositor. This situation is unsatisfactory since logically the degree of trust owed to depositors should be greater than for shareholders. The latter knowingly risk their money whereas depositors literally trust the bank with its safekeeping. We need to question why it is exclusively shareholders who (in theory) dictate the activities of the bank via the board, albeit subject to regulation, when the directors are steward for many more times depositors' funds with no accountability to them.

Finally, the public has a very strong interest in the non-failure of banks but no direct influence. The State has bailed out banking failure to the extent that is going to have macro economic consequences for decades to come, yet the control exercised by the State is very indirect via regulation and centralized banking supervision.

In summary, although it is a fundamental part of the financial system and almost a sacred cow, we believe the unitary board structure is no longer appropriate for banks and needs to be replaced. History will be a harsh judge if it is decided to continue with it without very good reason.

Proposed solution for governance

- 1. Creation of supervisory boards (SB's) for banks comprised entirely of public appointees** via the excellent system we have for this in Britain, guaranteeing open transparent appointment on merit and SB's free from any direct political interference. SB to provide nomination, audit and risk committees but note that this time it will be fully resourced to carry out these functions (see 4 below). It is possible, given further

consideration of this, that full time SB directors would be needed. But even if not full time it will certainly need to be substantial and SB directors must be paid accordingly.

2. **The primary role of the SB is to ensure the solvency of the bank** and thus protect depositors and the public interest by setting and monitoring risk limits commensurate with the size of the bank's capital base.
3. **Rigorous competence criteria for SB membership** and overall composition criteria guaranteeing the correct mix of *professional skills* including: lending banking, financial markets, risk management, IT, law and accountancy.
4. **Shareholder board to be chosen by shareholders with the primary purpose of revenue generation and shareholder value enhancement.** This board required to operate within the limits and framework decided by the SB. No problem at all with members who have no professional skills, for example people with contacts who can bring in business, who are known entrepreneurs and so on. Current governance rules already apply to this board for which, in fact, they were designed. The shareholder board may also contain non-executives as now to provide advice and entrepreneurial leadership and formulate strategy. The key point is that the shareholder board would have no supervisory or control responsibility to worry about and can concentrate on formulating strategy, accounting for this to the shareholders.
5. **Executive pay determined by shareholder board.** Provided there is no immediate threat to the solvency of the bank, as promoted by the SB, profits belong to the shareholders and are theirs to dispose of as they see fit, including to the executive in the form of their remuneration and themselves in the form of dividend. The SB would only be involved in this to the extent that the incentive structure created unacceptable risks, or solvency was threatened, but would otherwise have no say on the size of remuneration.
6. **Key control functions such as internal audit, risk management and compliance to report direct to SB** (and be paid and appraised by them to guarantee their independence). They will be the professional infrastructure on which the SB can rely for information about executive activity. This will plug the huge gap which currently exists since with no resources at their disposal, and very limited time available non-executives, no matter how good, are in a difficult position effectively to supervise the executive.
7. **External audit of banks above a certain size to be carried out by the National Audit Office paid for by direct parliamentary appropriation.** This audit will cover the effectiveness of risk management, governance and supervision by the SB as well as the financial statements. The NAO is the only independent auditor able to act effectively on behalf of the public interest as well as shareholders.

These changes would have negligible cost since it merely alters the disposition of resources rather than introducing additional ones. Money planned to be spent on increasing the number of banking supervisors would instead be spent funding supervisory boards. Transferring audit to the NAO will cost neither banks nor the taxpayer anything – the banks will pay for the NAO rather than a professional firm. Transferring reporting lines of the control functions to the SB to give them an effective infrastructure and will cost nothing extra. We are strongly of the view that cost is not an argument against the scheme. Since executive pay will be in the hands of the shareholder board as now, subject to revised rules which are occurring in any case, this scheme is entirely neutral on that issue. Finally, the presence of a fully independent supervisory board overseeing executive activity would lead to significant upgrading of banks from their current low position in the eyes of investors and not the reverse.

Bank capital requirements

- 8. Bank capital to be based exclusively on stress tests and reverse stress tests subject to a minimum standardized requirement. This requires new guidance on translating stress test results into capital requirements.**
- 9. Advanced approaches (IRB, AMA and market risk) no longer to be admissible for capital calculations. Upgraded but simplified broad brush standardised approach to be international backstop minimum to prevent regulatory arbitrage. All banks to rely on stress tests, not just big ones. No necessity for “cyclical reserves”.**
- 10. FSA in conjunction with Bank of England and HMT to publish quarterly extreme scenarios for bank stress tests to cover all key financial variables – interest rates, exchange rates, economic indicators etc. UK to urge for international stress tests to be published by BIS to ensure worldwide consistency.**
- 11. Mandatory quarterly stress testing and capital adequacy review to be carried out by supervisory boards following minimum published standards.**

Bank capital requirements

In terms of banks' capital, it has been acknowledged already in the Turner Review that there had been too much reliance placed on statistical models. This was actually apparent to many in the industry since the inception of Basel 2. However, we now suggest the logical next step which is simply to abolish advanced approaches for capital calculation. Advanced, statistical approaches are essential for proper day to day management but are inappropriate for capital assessment for which forward looking scenario analysis is the best method. This has been implicitly acknowledged by regulators worldwide who have been determining capital requirements directly from their own stress tests. If this is so it is surely a tacit admission of the ineffectiveness of the previous methodology.

Work does need to be done, however, to determine a sound methodology to translate forward scenarios into capital. Whilst Basel did require stress tests, there was always an important omission in specifying precisely what was to be done with the results. We have our own view on this to be published separately. Central to it are the so called “reverse stress tests” which we have advocated under the term “inverse risk logic” for many years.

But, it also should be accepted that there were mistakes in the way stress testing was introduced. This has also been acknowledged, namely the tendency to leave out of consideration sufficiently extreme events. The formula chosen, namely consideration of “extreme but plausible events” made it too easy to dismiss extreme scenarios on the ground that they were implausible. This was highlighted as a key failure of many banks in the Senior Supervisors' Group report on the crisis published in March 2008. Our prescription for this would be for be nationally (and eventually internationally) published extreme scenarios which the banks are required to use to ensure consistency. These results would then contribute to a reverse stress test by helping to clarify precisely the scenarios which would lead to non-viability of the bank as a going concern which we believe is the very place to start the capital assessment.

Again, all of this points to the need for supervisory boards with the time, resources and expertise to ensure these assessments are made objectively and are free from potential executive bias. But using the reverse stress test as the primary determinant of capital would result in a great simplification of the methodologies and focus the top of the banks' organizations on the critical areas of risk. All the analysis would be directed to assessing the likelihood of occurrence of the bank's failure rather than the traditional bottom up approach, and it follows principles which are long tried and tested in non-financial industries in assessing safety risks. Our experience of presenting this to bank boards out of the UK has shown a ready and willing acceptance of the principle and recognition of its effectiveness.

In conclusion, we believe many aspects of the current system of regulation for banks need a fundamental rethink. Central principle of separation of duties, and non-concentration of power in banks need to be subject to more effective control. In our view, by introducing publicly appointed supervisory boards composed of individuals with sufficient internal resources to carry out the role effectively, the issues within the Basel capital rules would be addressed by basic principles. A reverse stress test with the supervisory board being in a position to be objective and free from bias.

We are currently developing the detail of the above and will publish a substantial paper expanding the arguments. We have also considered at an early stage some other important considerations, such as the funding of the system. We strongly believe that, in common with countries such as the US, the system should be pre-funded with risk based premiums. That requirement is a departure from the current system and would need insurance and bank rating agency required assessments to set realistic premiums to be paid.

Actually putting all of this into practice would be a large job. However, the basic principles would be accepted and the infrastructure set up. Some things such as restructuring the capital rules could be done within the current framework, building on the major stress test carried out recently. If the will were there, the governance restructuring of HMG owned institutions merely by amending the legal documents (e.g. memorandum and articles of association) even under the current system could set the lead and we are sure demonstrate the use of effective principles enhancing and not destroying shareholder value.

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**Real Assurance Risk Management
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CHAIN OF ACCOUNTABILITY FROM DECISION TAKERS TO OWNERS

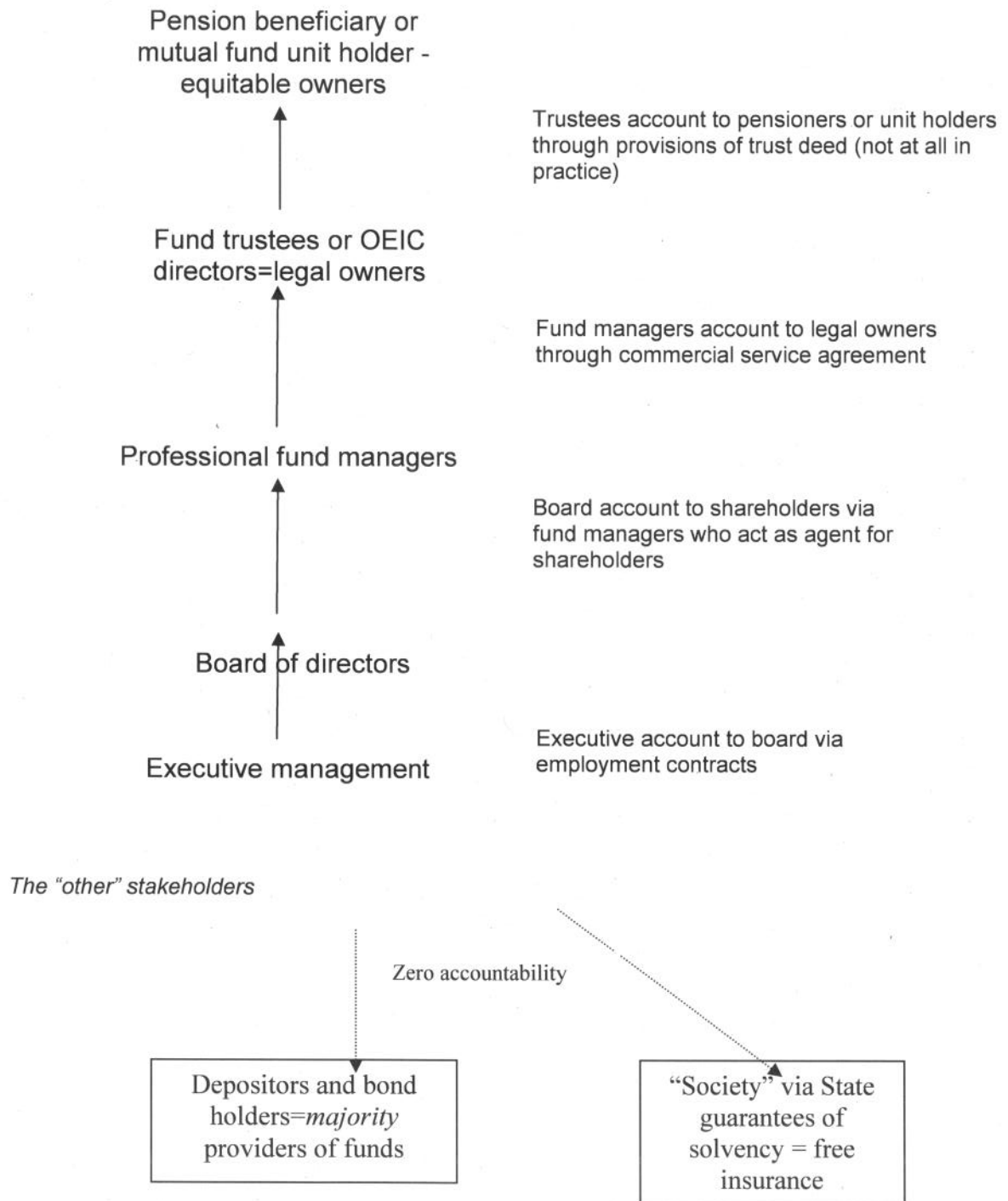


Figure 1