

# THE “NEW NORMAL” IN BANK GOVERNANCE

*...and some thoughts on its impact on MENA banks*



The 2007-8 international banking crisis uncovered long-simmering weaknesses in the structure, strategy and governance of global banks. Far from a solitary *annus horribilis*, the subprime crisis proved to be the beginning of a series, with the Greek/Euro crisis of 2010-12 and the on-going scandals of rate manipulation and compliance failures following close on its heels.

The eye of the cyclone being the western financial system, MENA banks were mostly--but not completely--spared. Their conservative balance sheets and “old school”, Basel I regulatory rules proved to be a lifesaver against the global tsunami. Nevertheless, MENA banks will suffer a lot of the consequences of the upheaval. This is a global industry with active international counterparties, investors

and clients. Regulators are sophisticated and well organised in international fora and networks, facilitating the development and implementation of global standards. MENA banks are therefore sooner or later bound to become part of the emerging “new normal” in conducting their business and organising their governance.

New regulation at international (Basel Committee on Banking Supervision-BCBS) and national level has already brought forth key changes that directly address the causes of the crisis: capital requirements have been significantly raised, a leverage “backstop” was introduced to stop banks from manipulating their risk weighted assets (RWAs) and liquidity considerations came into the Basel picture. More onerous requirements in

these areas were imposed on “systemically important financial institutions” (SIFIs). Regulators on both sides of the Atlantic require banks to develop detailed, realistic recovery and resolution plans; and they are being quite tough with their implementation: US supervisors have sent the majority of SIFI “living wills” back to the drawing board while some US banks have created special resolution plan committees at board level.

Overall, these requirements make it less attractive for institutions to keep growing their balance sheets in ways that put the whole banking system at risk. Of course, one of the key goals of all this effort is to banish “too big to fail”.<sup>1</sup> In other words, smaller institutions (and balance sheets) constitute a key aspirational element of the “new normal”. Some of the largest OECD economies have witnessed important regulatory efforts to keep banks from engaging in certain activities or, alternatively, to “ring fence” activities that are “systemic” (e.g. retail banking).

Another important aspect of the “new normal” is the way regulators view governance arrangements within individual banks. A radical shift occurred in this area. Past approaches ranged from completely indifferent to “light touch”. A supervisory “heavy hand” is currently replacing these approaches, spearheaded by G20 jurisdictions and the BCBS which significantly include KSA. Within the revamped Basel Pillar 2 mandate, supervisors have placed governance at the centre of both on-site and off-site supervision of the banks. In more active supervisors, substantive norms on governance have been developed, of a detail and scope unimaginable five years ago. Let us take a quick look at the most important areas:

**a. Remuneration:** Compensation was never perceived to be a very important issue for MENA banks-- probably rightly so. Close involvement of private or government shareholders ensured that agency problems were never acute in this part of the world. But in the west, the principal-agent relationship between shareholders and management is intermediated by share price and “independent” boards. If one believes that the alignment of these “abstract” shareholders with management in the relentless pursuit of shareholder value is good corporate governance, the banking crisis might be seen as too much of a good thing.

Big failures in the remuneration area became systemic risks and, eventually, important drivers of the global crisis, making remuneration a key focus of global regulators. The enormous remuneration packages, averaging an annual total of EUR 5,617,944 for a European top-25 bank CEO in 2007 (and much higher for their US counterparts), were largely composed of variable remuneration. Return on equity (ROE) was by far the most popular metric used. ROE is an indicator highly sensitive to leverage. It should therefore come as no surprise that ROEs of more than 20% observed in the noughties were, to a large extent, the result of excessively leveraging the balance sheet.<sup>2</sup>

Within the same European bank group, variable remuneration packages also had relatively short term vesting horizons. Bankers could make risky bets today and watch their institutions fail “from afar”, having already pocketed the gains.

All of this is now changing. The “new normal”, mandated by major regulators on the basis of FSB guidelines, wants a significant proportion

1 Sorkin, Andrew. Too big to fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System--and Themselves New York: Viking Press 2009

2 Ladipo D. & Nestor, S, Bank Boards and the Financial Crisis: A corporate governance study of the 25 largest European banks. London: Nestor Advisors, May 2009

of variable remuneration (at least 40% in the EU<sup>3</sup>) to be deferred and paid out over a period of three to five years in the future. Current proposals in the UK would take this period to an astonishing seven years for senior managers.<sup>4</sup> Regulators want variable remuneration to be “at risk” and be “clawed back” if pay-outs were based on false assumptions. And board remuneration committees, now mandatory for all large banks, are responsible for setting the quantum of the remuneration for a significant number of “risk takers” within the organisation.

Interestingly, our research at Nestor Advisors suggests that the CEOs of some of the best-performing large European banks received little variable remuneration. Among the three Swedish banks that come at the top of our three-year performance ranking none has a bonus scheme<sup>5</sup>. Moreover, the Swedish bank boards that approve variable pay would typically tie it not to individual but collective performance, and pay it out to bank employees in a fairly egalitarian way, deferred well into the future.

**b. Risk governance, controls (and culture):** The absence of risk management “ownership” by bank boards was identified as another proximate cause of the crisis and of various conduct failures. Regulators on both sides of the Atlantic now require bank boards to constitute stand-alone risk committees<sup>6</sup>

(BRCs) made up exclusively of non-executive directors. In Europe, this is the case in 13 of the top-25 banks compared to 5 in 2007. In the US, SIFIs are now required to have risk committees with extensive responsibilities. Some of the largest banks that failed during the crisis did not have risk committees (Bear Stearns); or, in the banks that did have them, the committees met only rarely (Lehman Brothers).

Rules have also been established to ensure the seniority, competence and authority of the risk management function, and its head, the Chief Risk Officer (CRO) – what we at Nestor Advisors call CRO “gravitas”<sup>7</sup>, and to place the responsibility for maintaining the adequacy of the function squarely on the board and its risk committee<sup>8</sup>. As a result, all CROs are today members of executive committees, while in 2007 only 20 were sitting in ExComs in the top-25 European banks.

Most importantly, bank boards and their risk committees now have the responsibility for setting the risk appetite, i.e. the amount of risk the bank is willing to take in order to fulfil its business objectives. In most banks, boards were the active setter and “owner” of high-level quantitative boundaries on risk taking<sup>9</sup>. They were not used to such a rigorous, top-down process. In the best of cases, they perceived their responsibility to

3 Directive 2010/76/EU Annex I - Note also that the CRD IV limits the amount of annual variable remuneration to a maximum of two times fixed pay following explicit shareholder approval (Directive 2013/36/EU (CRD IV), Article 94), European Union, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32010L0076>

4 PRA CP15/14/FCA CP14/14, Strengthening the alignment of risk and reward: the new remuneration rules Prudential Regulation Authority, Bank of England, July 2014, <http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp1514.aspx>

5 Nestor Advisors, Cultural revolution: culture and corporate governance in the largest 25 European banks London: Nestor Advisors, (forthcoming December 2014)

6 Directive 2013/36/EU (CRD IV), Article 76, [http://ec.europa.eu/internal\\_market/bank/regcapital/legislation-in-force/index\\_en.htm](http://ec.europa.eu/internal_market/bank/regcapital/legislation-in-force/index_en.htm) & US Federal Reserve System, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations; Final Rule, March 2014, <http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf>

7 Lawton C. & Nestor S., Bank boards after the flood: The changing governance of the 25 largest European banks, London: Nestor Advisors, October 2010 & IIF, Governance for strengthened risk management, Washington, DC: Institute of International Finance, October 2012

8 See for example Directive 2013/36/EU (CRD IV), Article 76.

9 FSB, “Principles for an effective risk appetite framework”, Basel: Financial Stability Board, November 2013

be limited to the oversight of the bank's risk profile as it developed from the bottom up. Now, in addition to setting the risk appetite, regulators also want boards to own and approve the internal capital and liquidity adequacy assessment processes (ICAAP, ILAAP). These are highly technical exercises requiring an advanced understanding of the business of banking.

In these areas, many MENA regulators have been quite active in adopting norms similar to global standards. For example, the Saudi Arabian Monetary Authority requires boards in SIFIs to approve a risk appetite statement as well as ICAAP, to form risk committees and to have independent risk functions.

And then there is risk culture...

Banking (and risk) culture: In a recent interview, Archbishop Welby, a member of the UK Parliament's Commission on Banking Standards, quoted Peter Drucker to remind us that "when it comes to banking, culture eats regulation for breakfast every morning".<sup>10</sup> Welby is referring to an astonishing number of conduct failures among global banks which has led to a barrage of sanctions by regulators. BNP Paribas settled for USD 8.9 billion to federal and state government agencies while agreed to pay USD 16.6 million in the context of a settlement with OFAC. Irrespective of the sometimes legally dubious reasoning behind these sanctions, most banks have not dared challenge them--and for good reason. The trust of their clients and the public at large is at such a low point that self-righteousness would only make matters worse.

Welby is also alluding to the misguided view that regulation alone can fix all that. It cannot... but it is certainly trying! The draft guidance of the European Banking Authority (EBA) on the new Supervisory Review Process (SREP) requires supervisors to "encompass the assessment of banking and risk culture" in their already quite extensive on-site assessment of banks' "internal governance"<sup>11</sup>. The Institute of International Finance (IIF), the industry's global think tank/lobby, asks banks to regularly self-assess their "risk culture"<sup>12</sup>, the key "indicators" of which are<sup>13</sup>: tone at the top, accountability, effective communication and challenge; and incentives.

At Nestor Advisors, we view culture as "process over time", i.e. the main accepted paths that the members of an organisation follow in order to accomplish their tasks—crucially including conducts and behaviours. Such similarities in behaviour can emerge only over time—it is not enough to mandate change, you have to live it. "Process over time" can only reflect the (real, as opposed to website) values that members of an organisation hold dear. It also encompasses views (and expectations as to other members' views) on the firm's identity, continuity and relationship with clients.

The subject of culture is too complex to be further discussed within the scope of this brief paper. Suffice it here to make two key points:

i. While culture is "real" and important, it can only be changed by targeting specific incentives, policies and conducts which impact on "the way we do things". This targeting must be sustained and consistent over a period of time. Thus, while boards

10 Financial Times 11/10/2014, <http://www.ft.com/cms/s/0/6b91b4fc-506b-11e4-8645-00144feab7de.html?siteedition=uk#axzz3G0mx4Pm7>

11 EBA/CP/2014/14, July 2014, [https://www.eba.europa.eu/documents/10180/748829/EBA-CP-2014-14+\(CP+on+draft+SREP+Guidelines\).pdf](https://www.eba.europa.eu/documents/10180/748829/EBA-CP-2014-14+(CP+on+draft+SREP+Guidelines).pdf)

12 IIF, Risk Culture, "Reform in the financial services industry: Strengthening practices for a more stable system", December 2009

13 FSB, "Guidance on supervisory interaction with financial institutions on risk culture: A framework for assessing risk culture", April 2014, <http://www.financialstabilityboard.org/publications/140407.htm>

need to regularly review the banking and risk culture of the organisation, cultural change as such can only be achieved by setting specific policy, incentive or conduct change objectives.

ii. There is such a thing as a “bad” culture which is more or less what regulators are trying to target. However, the opposite is not true. It is counterproductive for boards to aim for a universally “good” culture. Each institution has its own history of developing its business and dealing with its environment. Some are more individualistic than others; in some, the way people and products evolve is slower and more “embedded”, while in others constant change is “part of the DNA”. Finding the language to recognise these differences is important<sup>14</sup> but targeting an “ideal” culture might risk “throwing the baby with the bathwater”.

### **c. Board composition and effectiveness:**

Other areas claiming supervisory attention in the “new normal” are board nomination, composition and effectiveness. Previously these were subject to “softer” capital markets regulation, such as CG Codes. But this is rapidly changing via mandatory banking regulation.

Contrary to the spirit of most European company laws and continental traditions, the board of a bank is now expected to be responsible for its own composition and has a central, explicit role in the nomination process.<sup>15</sup> Large banks are required to have nomination committees who are expected to maintain an active interest in the board’s composition needs and actively plan NED and executive

succession. There is a minimum content of independent directors required in order to populate audit, nomination and remuneration committees while non-executives are required not to sit on too many other boards so that they may effectively discharge their ever increasing responsibilities, as discussed above<sup>16</sup>.

Boards are also required to maintain a watchful eye on their own collective effectiveness and engage in annual evaluations whose adequacy will be checked by supervisors. Most importantly, supervisors are taking an active stance as regards the individual suitability of board directors and of other key function holders. In contrast to a fairly perfunctory “CV” approach on classic fit and proper elements (reputation, criminal record, absence of bankruptcy etc.), supervisors are now directly interviewing and authorising board members. Also, they are ready to hold boards (and their nomination committees) accountable for not having done their homework in vetting individual fit-and-proper and competence. Board members’ contribution of knowledge, skills and experience is expected to become an integral part of annual board reviews.<sup>17</sup> In the UK, supervisors are proposing a double track regime: approval for the board members and most senior managers heading key functions (e.g. CEO, CFO, CRO etc.); and a self-administered certification regime for lower level managers, a system whose robustness is subject to supervisory review<sup>18</sup>.

Currently, MENA bank boards are essentially composed of shareholder representatives with limited banking experience and way too many other engagements. This might

14 Power M., Ashby S., Palermo T., Risk culture in financial organisations, London: London School of Economics, 2012, <http://www.lse.ac.uk/researchandexpertise/units/carr/pdf/final-risk-culture-report.pdf>

15 EBA, Guidelines on Internal Governance (GL44), September 2011, [http://www.eba.europa.eu/documents/10180/103861/EBA-BS-2011-116-final-EBA-Guidelines-on-Internal-Governance-\(2\)\\_1.pdf](http://www.eba.europa.eu/documents/10180/103861/EBA-BS-2011-116-final-EBA-Guidelines-on-Internal-Governance-(2)_1.pdf)

16 Directive 2013/36/EU (CRD IV), Article 91

17 Idem at Article 88

18 FCA CP14/13/PRA CP14/14, Strengthening accountability in banking: a new regulatory framework for individuals, July 2014, <http://www.fca.org.uk/static/documents/consultation-papers/cp14-13.pdf>

*“In the “new normal”, risk management, finance, compliance and internal audit are increasingly independent from management. They report directly to the board and are slowly being transformed into quasi-agents of the supervisor. Perversely, this might result in worse, not better, controls: it might significantly weaken the authority of top management to effectively run the bank and to get timely, adequate information. It is likely that, in the “new normal”, management might need to build parallel control channels.”*

sit awkwardly with the “new normal” emphasis on board expertise and increasing responsibilities. Moreover, shareholder dominated “constituency” boards will have trouble meeting the emerging requirement of board responsibility for nominations, discussed above.

What does all this mean for the future of banking institutions and their boards? How will they look a few years from now?

On the composition front, the emphasis is moving from “idle” independence (based on historic, general corporate governance standards) towards competence. As a result, bank boards are becoming more and more “professional” and hands-on. The need for expertise combined with the increasing legal liability of bank directors result in the significant limitation of the pool of available board members.

Significantly more hands-on boards might mean less “independent” boards, at least in the traditional sense of completely disinterested

outsiders sitting as non-executive directors (NEDs). The example of Santander, one of the most successful European banks during and after the crisis, is interesting in this respect. The Santander board asks its NEDs to work quite hard: in 2013 its BRC met 97 times while its AC met 12 times. The board is quite large because it has a significant number of executives. But these “additional” executive directors (i.e. in addition to the CEO and CFO who are “standard” members in many unitary bank boards) are not the traditional heads of businesses who usually sit on other boards with significant executive presence. They are rather “roaming” executives with very broad portfolios and oversight responsibilities. For example, the “CRO” is not the head of the risk function but its overseer, and also the overseer of liquidity management. The executive chairman can sit in most executive committees but does not run the bank; idem for the director who heads strategy. In effect, the distinction between NEDs and executive directors is quite blurred.

All of the above might result in bank boards becoming smaller and more hard working—neither of which is a bad thing. Our own findings suggest that this has already started happening: from a median board size of 15 in 2007 bank boards have steadily, albeit modestly, come down to 14 in 2013 . In MENA, boards are already quite small<sup>19</sup>; our in-house research indicates that median board size in MENA is 11. Ironically, they might need to become larger as a result of a “double whammy”: (a) outside pressure for more expertise, more diversity and a heavier workload (b) internal opposition in removing non-expert shareholder representatives from the board.

Regulatory pressure is also resulting in the significant centralisation of control functions. In the “new normal”, risk management, finance, compliance and internal audit are

<sup>19</sup> Idem

increasingly independent from management. They report directly to the board and are slowly being transformed into quasi-agents of the supervisor. Perversely, this might result in worse, not better, controls: it might significantly weaken the authority of top management to effectively run the bank and to get timely, adequate information. It is likely that, in the “new normal”, management might need to build parallel control channels. As Nassim Taleb points out<sup>20</sup>, such redundancy and duplication in the control systems might actually be beneficial. But it is expensive at a time where profit generation is key, both in terms of increasing the appeal of banks to equity investors and in maintaining adequate capital adequacy.

In fact, it is quite worrying that compliance costs (including control centralisation) and exponentially increasing regulatory complexity<sup>21</sup> set the bar for banks quite high in terms of size and scale. Only large institutions will be in a position to effectively respond to regulatory requirements. While regulators struggle to banish too-big-to fail, they are also pushing banks to become bigger. Moreover, Haldane and others point out that the mind-boggling levels of complexity in bank regulation might have unintended consequences. Rigid, detailed regulatory templates might “blind” boards and executives to big emerging risks, especially of the “fat tail” variety. A highly prescriptive and monolithic approach in identifying, reporting and managing risk might crowd out alternative views and dampen challenge, this much sought after cultural “good”. One could be forgiven in viewing Basel as a “Stalinist” regime of sorts.

Whether problematic or not, MENA banks will have to move closer to emerging “new normal” governance standards. If they are found to significantly diverge they might face

non-trivial costs, especially as they seek capital and funding through the wholesale markets. Rating agencies, the gatekeepers of these markets, are becoming more and more vigilant on governance issues. Here are three important challenges that MENA boards might face and some potential solutions:

i. The need for fewer “outside” engagements of individual directors might be met by the appointment of more independent outsiders, trusted but not directly accountable to shareholders. Potentially, more executives might also need to populate boards—maybe of the Santander variety.

ii. The need for more effective, knowledgeable boards should translate into more in-depth, regular board evaluations and on-going director development programmes. It might also drive more engagement in planning board and top management succession through tailored nomination policies and procedures;

iii. The need for a more effective control environment and top-down governance by the board might be met through regular outside reviews of corporate and risk governance. In their turn, these might drive the explicit “ownership” of values by the board.

One thing is sure: the pre-crisis days of unbridled bank expansion and “black box” corporate governance are not coming back in the foreseeable future. The “new normal” is here to stay.

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<sup>20</sup> Taleb, Nassim. *Antifragile: Things that gain from disorder*. New York: Random House, November 2012

<sup>21</sup> Haldane G. Andrew. *The dog and the Frisbee*, Speech, Bank of England, August 2012, <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf>