WHY ARE BANK BOARDS DIFFERENT?

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Not many sectors can claim to be able to thoroughly disrupt the world economy. Crisis after crisis, the banking sector has shown that it can do just that. If only because of the "systemic risk" posed by the banking sector, being on the board of a bank is like no other board position in any other sectors of the economy.

Banks vary widely by size, product range, customer base, international reach, and so do their boards' composition and roles. Despite the variety, many governance experts have noted that bank boards are different, and have pointed out various reasons why that might be. My own experience certainly confirms this view. I have been on bank boards for over 10 years and, from that vantage point, have observed, and have had to deal with, the implosion of the "Internet bubble", followed by the "great moderation", leading itself to the 2008-10 financial crisis, and now the aftermath of the crisis. My thoughts on "why? how? and so what?" are as follows.

Apart from the "systemic risk" posed by many banks (the so-called "SIFIs" - Systemically Important Financial Institutions) to the financial system and therefore to the economy at large, I believe there are five main reasons why being a bank director is different. Some sectors present some of these elements, but none have all five simultaneously.

The business of a bank is complex. In most sectors you do not need to be an expert at the underlying products or service to be a good director. For example, you do not need to be able to write complex code to sit on the board of a technology company, nor be able give technical conferences on the future of network technology to sit on the board of a telecom company, and still do your job well. In the case of a bank, I believe you do need to understand the underlying products. This is because the core business of a bank is to manage financial risk, and in order to oversee risk you need to understand what you are overseeing.

In addition, the business of a bank is very fast-moving. Apart maybe from the really small local ones, banks are directly exposed to international economic and financial fluctuations. These can change overnight and a bank must be prepared to react. For example, funding and liquidity conditions may change in less than 24 hours. If a bank is dependent on wholesale funding, even only partially, its liquidity may dry up quickly. It needs to prepare for that eventuality and have an action plan in place.

Then, banks have two characteristics, shared by some other sectors like technology, but which are still unique: they are highly people dependent, and they rely heavily on technology – particularly on their IT networks.

Many recent examples have shown how dependent banks are on the competence and ethical behavior of their people. Staffing is key for adequate risk management, proper conduct and ethical behavior. Codes of conduct, processes, internal controls, internal audit play a key role of course. But all of these can be circumvented by the wrong people, from the "rogue trader" to the unethical "money-laundering" executive focused on his annual bonus. And remuneration and incentives can indeed have perverse effects, as the financial crisis had abundantly demonstrated, even where there has been no unethical behavior.

At the same level of importance are IT networks and processes. Banks are customer-facing risk management businesses sitting on large, complex, and often antiquated legacy IT networks. Crises exposing weaknesses in these areas have had a tendency to pop-up almost daily in recent months. Cyberattacks are a constant worry and a constant threat for any financial institution. And, to complicate things even further, digital banking is disrupting traditional business models, whether retail banking, payment transaction and processing, or consumer credit. As a result IT costs have exploded and will continue to be one of the largest items of bank operating costs and capex. Understandably, bank managements, board and regulators have been actively trying to beef up their competences in the digital space. In no other sector are "digital directors" more in demand, but have also been harder to find.

Finally, banks have to please multiple-stakeholders. This is true of any company – it must cater to employees, clients, shareholders (whether public or private), public authorities, etc. But banks are not only business entities, they also have a quasi "public service" role. Consequently, reputational risks are high in all aspects of their business, and public authorities and regulators have a natural and justifiable tendency to keep a close watch on how banks are managed – some would say, to the point of interference.

These specificities drive aspects of the workload of a bank board that are not common on other boards, or at least not to the same extent. Some aspects will be similar whatever the board (performance review, financial disclosure, HR discussion, etc.), but at least four, in my experience, will be very different.

Banks operate in a highly regulated environment. Many companies do not, and regulation will then hardly be discussed at board level (other than through compliance reviews, for example). But for a bank, regulation is not only a large part of the board agenda, it also drives a large part of strategy and business development. This raises the difficult questions of how "expert" a bank director has to be in regulatory questions, how much he or she can rely on internal teams, how he or she needs to stay up-to-date on a constantly changing regulatory environment, how he or she gets updated on regulatory compliance, and how much time the board needs to spend on regulatory matters, as these could easily occupy the entire agenda.

In addition, every bank board understands that, in today's world, it needs to oversee ethics and compliance very seriously indeed. Processes must be in place, internal control and internal audit teams must be given the right authority and independence, but the "tone-from-the-top" also matters enormously. This is where top management and the board come in. Recent spectacular fines from various authorities have shown that, whilst ethical violations may occur even in the best managed banks, the quality of the control environment and the way in which these violations are dealt with are key to assessing the size of the penalty. Ethics and compliance are a now standing item of every bank board meeting agenda (rather than once or twice a year in most other sectors), and banks boards increasingly have dedicated committees on these matters (rather than have them dealt with by the audit committee). Ethics and compliance issues are complex and difficult to oversee, even with the best management teams and processes.

Bank accounting is complex. Even worse, it is often non-transparent and counter-intuitive to non-financial and accounting experts. We all know that accounting rules are sometimes a little surprising, as they try to capture the business reality into a set of numbers. In the case of banks, these rules are both highly complex (even in non-financial companies, the most complex accounting aspects are often related to the accounting of treasury and investment instruments), and often downright odd (for example, the IFRS treatment of interest rate variations of bank debt instruments). As a result, and unless the director is already well versed in bank accounting, a new appointee should really spend a few years attending the audit committee before he or she start to really understand the financial results and the board discussion around them. In most other sectors, the "induction" is much quicker.

Finally, as mentioned above, risk management is the "core business" of a bank (and increasingly also, proper management of its IT!). Understanding risk requires a deep understanding of the bank's products and the markets it operates in. The assessment of risk and the risk appetite of the bank are the other side of the bank's strategy. The Risk Committee, now obligatory in many jurisdictions, is not only about risk management, but very fundamentally also about strategy. In no other sectors are risk and strategy so closely linked.

All of the above has profound consequences both for board members and for board organizations.

A candidate to a bank board position will rightly worry about the time commitment (and, correspondingly, the remuneration), the importance of regulatory aspects, the responsibility and personal accountability, the reputational and financial risks, and the potentially frustratingly large gap between the management's and the board's information. These are worries for any director in any company, but they are heightened for a bank board member. In addition, regulators are now so closely involved in all aspects of decision making that directors can also worry that they are disenfranchised, and consider that the real board is the regulator.

From a board's perspective and from a regulator's perspective, composing the right board is not easy. The example of the "digital director" is just a case in point. Obviously, knowledge of the digital world is necessary at board level, if only to engage in the right oversight and value-added discussions with management on IT, cybersecurity and digital banking. At the same time the candidate needs to have an understanding of the financial world, of governance and the board's role, combined with significant business experience. The fact that boards and regulators seem to be struggling in this area shows that the positions are not that easy to fill. The same could be said about retail banking experience, risk management experience, etc.

Most countries have "best-practices" governance codes which address issues such as composition, number of directors, committees, etc. They are more or less compulsory, but generally tend to play a positive role in unifying board structures, organizations and behaviors around common tested practices. In the case of banks, legislators and regulators have concluded from the financial crisis that "best-practices" codes are not enough, and have stepped in much more heavily. Multiple international (FSB, Basel Committee, ECB, etc.) and national (FSA, FED, etc.) oversight and regulatory bodies have mandated how boards should be structured and organized. Whilst there are still many differences between regions and countries, certain general themes emerge: composition of the board, limitation on board members' other activities, number of committees (at least audit, risk, remuneration and nomination), detailed prescription of the role of these committees, increasingly separation of chairman and CEO, detailed prescription of how risk should be analyzed and the risk function's independence guaranteed, rules on remuneration both in substance and disclosure, etc. Legislators and regulators even go into how the bank's businesses should be organized and, at times, ring-fenced, giving rise to the need for additional boards with separate regulatory oversight.

In summary, I believe that being a bank director is like no other job. And after reading this long list of constraints, with the added prospect of having to work hard and the potential of being frustrated, it would be fair to ask why one would ever contemplate joining a bank board. My personal answer is very simple: it is one of the most demanding but interesting jobs I can think of.

Every negative has a positive, if the board dynamics are right and the quality of the board is high. A bank board is a fascinating "window" onto world finance and the world economy, it is intellectually and professionally challenging, it is varied and fluctuating, and banking is a highly competitive sector where a differentiating strategy is difficult to design and implement. Finally, going back to my observation in the introduction, in very few other board positions can you have the impact on society you can have as a bank board director.