

Shaping bank governance in a new era

Enhanced oversight versus radical reform

Introduction

Lax board governance is often cited as one of many proximate factors giving rise to the present financial crisis. In recent months, investors and regulators have called for significant reform in board governance and, for a number of financial institutions (FIs), demanded different board rosters. Stakeholders have made it clear that they plan to hold directors more accountable, in particular for decisions on risk and on compensation structures. In this environment, boards are reviewing their own practices and asking themselves tough questions about opportunities to improve.

To support their efforts, Tapestry Networks launched an intensive research effort beginning in late 2008, speaking with over 50 FI board directors,¹ current and former FI executives, regulators, investors, and other thought leaders from Europe and North America to date. Ernst & Young is sponsoring this research as part of its deep, continuing commitment to board effectiveness and good governance.

Outputs from the initiative will include a series of briefing notes, of which this is the first, exploring how bank directors can play a proactive leadership role in shaping the future of the industry. These publications are intended to inform directors of leading financial services of the insights we are gathering with a view to shaping future dialogue with them, and to support directors' conversations with their management teams and key stakeholders as boards adapt their own governance approaches. This and subsequent briefing notes may be shared freely.

Executive summary

This briefing note outlines the key themes from the research effort through June 2009:²

- **Boards get some blame, albeit bigger forces drove the crisis** (*page 2*)

Virtually every thoughtful analysis of the crisis cites macroeconomic imbalances, regulatory failure, and fatal flaws in the intricate intellectual foundation upon which economic and regulatory policies were based as the major culprits, but boards do not escape blame. Critics assert that too many FI boards lacked industry acumen, missed critical opportunities to ask probing questions of management, incentivized excessive risk taking through executive

¹ In this document, "director" refers to non-executive, non-employee board members on a firm's unitary or supervisory board.

² The perspectives expressed in this paper are solely the responsibility of Tapestry Networks, and do not necessarily reflect the views of any individual institution, its directors or executives, or Ernst & Young. Quotes in italics are drawn directly from conversations with participants in the research.

compensation arrangements, and were focused more on board compliance than on helping shape company strategy and assessing management's grasp of the risks in its business.

- **Higher expectations of the board may lead to a change in its character** (*page 3*)

Directors are keenly aware that expectations for FI boards are higher today than ever before. Their decisions on how to meet those expectations depend in large part on whether they seek merely to enhance board oversight, or whether they desire substantial governance reform, designed to give boards greater accountability for bank performance. Increasingly, shareholders and regulators appear to be taking the position that boards should be held to account for FI success and performance and are pressing for reforms on that basis – reforms that may transform boards' character.

- **Directors and others have proposed ways to strengthen FI corporate governance** (*page 5*)

Directors are considering improving board performance in a number of key categories, including risk governance, executive compensation,³ board organization and operations, and strengthening engagement with regulators and long-term investors. They recognize that each of these categories contains a number of areas of emerging consensus among regulators, investors, and industry itself on changes that will be required at the board level.

Boards get some blame, albeit bigger forces drove the crisis

Quite a number of thoughtful, independent, and well-researched and documented analyses of the financial crisis are now available.⁴ To a considerable degree, these reports converge on common themes under the headings of macroeconomics (e.g., trade flows, housing bubbles, savings rates, monetary and fiscal policies), regulatory failure, market failure, over-leverage (in financial institutions and in households), pro-cyclicality in the system, weak risk management (both systemic and micro-prudential⁵), financial product innovation, risk-inducing remuneration, personal greed, and malfeasance.

Suffice it to say that forces beyond the control of any single person, institution, or nation were undermining the global financial system for many years – even as that system appeared to be thriving. Throughout this period, experts from both the public and private sectors repeatedly examined the system and declared it safer than ever before.

The reports implicitly blame almost everyone for the crisis. None place central blame with boards of directors – an acknowledgement of the limits of what can be expected of boards. One former

³ “Remuneration” (UK) and “compensation” (US) are used interchangeably in this document, referring as a noun to executive pay itself and as an adjective to the respective committees overseeing pay and pay structure.

⁴ See, for example, the High-level Group on Financial Supervision in the EU, *Report* (Brussels: The High-level Group on Financial Supervision in the EU, 2009), available at http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf, and Financial Services Authority, *The Turner Review: a regulatory response to the global banking crisis* (London: Financial Services Authority, 2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

⁵ Micro-prudential risks pertain to individual institutions, while macro-prudential risks pertain to an entire economic system. In this section and throughout the document, discussions of risk and risk governance refer to micro-prudential risk.

European regulator, when asked whether he thought bank boards could have foreseen and prevented the financial crisis, responded, “*Not really.*”

Others, such as former GE chairman and CEO Jack Welch, stress the importance of being realistic in assessing what boards could have done to prevent the crisis:

Without doubt and with perfect hindsight, some boards could have acted more boldly in trying to avert the current meltdown. But the real fallacy of corporate governance in this crisis is not what boards did and didn't do. It's what was expected of them ... The list of guilty parties involved in bringing on the current economic situation is long, and boards do belong on it. Just don't put them near the top. That would give them too much credit for a job they couldn't do.⁶

However, misplaced expectations or not, directors do not escape blame. As Hector Sants, chief executive of the Financial Services Authority (FSA), put it, “Evidence from the current crisis indicates that some [non-executive directors] have struggled to fulfill their role of providing strong independent oversight of the executive management.”⁷ Investors agree. The International Corporate Governance Network, a group of institutional investors with \$9.5 trillion in assets under management, stated, “It is now widely agreed that corporate governance failings were not the only cause of the crisis but they were highly significant, above all because boards failed to understand and manage risk and tolerated perverse incentives.”⁸

Higher expectations of the board may lead to a change in its character

While academics toil over the fine points of the causes of the crisis, politicians are more concerned with swift reforms – some of which may later be decried as knee-jerk reactions. These reforms assume boards need to change significantly.

Critics point to clear shortcomings in FI boardrooms

Where did boards fall short, according to critics? *Bank Director* summed up the overarching criticism of many: “The overall impression is that many bank boards were somehow asleep at the switch, either blissfully willing to accept unreasonable risks, or unable to comprehend – or unwilling to challenge – the strategic paths their managements were leading them down.”⁹

Specific charges that have been made against FI board members include:

- Insufficient knowledge and financial industry expertise to deal with complex risk issues.

⁶ Jack Welch and Suzy Welch, “How Much Blame Do Boards Deserve?” *BusinessWeek*, January 14, 2009. Available at http://www.businessweek.com/magazine/content/09_04/b4117102356265.htm.

⁷ Hector Sants, “The regulator's role in judging competence.” Speech at the Securities & Investment Institute Conference, May 7, 2009. Available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0507_hs.shtml.

⁸ International Corporate Governance Network, *Second Statement on the Global Financial Crisis* (London: International Corporate Governance Network, 2009), 1. Available at http://www.icgn.org/files/icgn_main/pdfs/news/icgn_statement_on_the_financial_crisis_23_march_09.pdf.

⁹ John R. Engen, “Trying Times, Complex Solutions,” *Bank Director*, October 2008. Available at http://www.bankdirector.com/issues/articles.pl?article_id=11978.

- Insufficient engagement – directors failed to challenge senior management and the “*ex-rocket scientists*” who supervised the building of models and the creation of structured products.
- Insufficient focus on questions of strategy, performance, and risk due to a preoccupation with compliance-related activities.
- Insufficient independence from management and a corresponding inadequate degree of focus on shareholder interests.

Policy responses are narrowing options for boards of directors

Policymakers and those who influence policy are struggling to choose between a set of proposals designed merely to enhance the board’s oversight effectiveness and a set of proposals intended to transform the board into a body that shoulders a higher degree of legal responsibility for the institution’s long-term success.

This is a pivotal choice. Do we want boards that operate a bit better (i.e., improvement), or do we want boards that operate quite differently and with a different purpose (i.e., reform)? The detailed proposals outlined in the next section can be combined and implemented in a wide range of ways, such that they achieve either intended result.

Events are unfolding rapidly, and in some areas, FI directors may not be given the choice between those two alternatives. Activist shareowners and regulators are considering a wave of changes that assume new levels of accountability to shareholders, regulators and the public are required. They are looking for signs that boards are instituting substantive changes in governance. According to research participants, it is not unrealistic to expect that:

- Boards will be composed in significant measure by former (i.e., retired) bankers.
- Board members will be expected to engage actively and in some detail with key executives, with regulators, and with shareowners.
- Board members will require a greater level of support in the form of dedicated staff and assistance from outside experts in multiple disciplines.
- Boards will regularly meet management’s proposals with counter-proposals to ensure active and informed debate.
- Because of their enhanced level of responsibility and additional activities, directors will need to spend a significant fraction of their time on board duties. The role of committee chair may become a full-time responsibility; indeed, Mr. Sants has noted that meeting new expectations “will require [non-executive directors] to work on a more full-time basis.”¹⁰
- Decisions on executive pay will be highly circumscribed by regulators.

¹⁰ Hector Sants, “The Crisis: the role of investors.” Speech at the NAPF investment conference, Edinburgh, March 11, 2009. Available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0311_hs.shtml.

- Management decisions – and boards’ oversight thereof – will be second-guessed by regulators.

One board member we interviewed, however, felt that (in the US) legislatively mandated requirements for board governance would likely be modest and would not amount to substantial reform. Legislating say-on-pay and easier access to the proxy for investors, for example, might release enough political pressure from the system to restore stability.

Questions for directors:

- ? To what extent is the board now experiencing pressure from regulators and other influencers to change governance practices? What are the pros and cons of this pressure for the board, management, and shareholders?
- ? Independent of outside views or potential legislative requirements, how far beyond their traditional oversight responsibilities do you believe boards should go?¹¹
- ? How will the board respond to requests from regulators and investors to demonstrate concrete improvements in governance? What are the highest priority opportunities for improvement?

Directors and others have proposed ways to strengthen FI corporate governance

Choosing among the governance proposals being placed on the table requires a nuanced understanding of what makes an effective board. Some financial institutions did fare much better than others when the crisis hit: to what extent was their relative success due to a superior board? And, to the extent that boards do seem to make a difference, can one discern a pattern of best practices that could be embodied in prescriptive policy? We have seen no analyses or correlations to date.

Several of our interviewees make a compelling case that it is the soft and subtle dynamics of a board that actually create or destroy its effectiveness. Is the chief executive open to dissenting viewpoints? Do the CEO and non-executive chairman (where this model exists) complement each other well, or do they work either to undermine each other or to present a unified and impenetrable front to other non-executive directors? Are forums for serious debate available to the board, or are meetings primarily used for rhetoric and “point scoring”? Board independence and engagement, generally acknowledged to be positive attributes, may in practice be more about an attitude of bold inquisitiveness and willingness to challenge than about a set of rules.

Nevertheless, policymakers seem intent on arguing from a standpoint that emphasizes form over substance and on drawing from a reservoir of ideas long advocated by governance reformers, such as proxy access and separation of the CEO and chairman roles.

¹¹ Traditional oversight responsibilities include hiring, firing, and compensating the CEO; monitoring compliance; monitoring performance; approving corporate strategy; ensuring correct tone at the top; and crisis management.

Most proposals for improving FI board governance focus on some combination of the following:

1. Enhancing risk governance
2. Adopting compensation principles that discourage inappropriate risk taking
3. Reshaping board organization and operations
4. Increasing engagement with regulators and long-term shareholders

1. Enhancing risk governance

When discussing the board's role overseeing risk, one must distinguish systemic from micro-prudential risk. As one director said, *"Much of the force of the crisis derived from systemic risk, and that is a matter for supervisors or regulators. Individual banks have neither the perspective nor the information to assess it properly."*

US Treasury secretary Timothy Geithner criticized investors and banks for taking "risks they did not understand."¹² Goldman Sachs chairman and CEO Lloyd Blankfein conceded, "Complexity got the better of us."¹³ One research contributor went so far as to say, *"Manifestly, no one can rely on banks' risk management."* A director with whom we spoke summed up the sentiments of many of those interviewed: *"The whole issue of risk is very pressing for financial services firms ... Everyone is looking for answers and asking what we [as board members] can do to assure that [a disaster like the current crisis] doesn't happen again."*

While FIs may still be *"looking for answers,"* there are several areas where consensus is emerging among industry, regulatory authorities, investors, and other stakeholders about changes to risk governance that will be required at the board level.

Directors need to question management more actively on risk matters

The FSA stated in its Turner Report that the crisis "demonstrated the vital importance of non-executive challenge to dominant chief executives pursuing aggressive growth strategies."¹⁴ Separately, the FSA CEO has noted that "ultimately, [non-executive directors] will need to demonstrate competence with regard to risk management, regulation, and – importantly – the business model of the firm."¹⁵ The FSA is not alone in setting out such expectations. See ["Proposals for enhanced risk governance" on page 7.](#)

In terms of the risk component, while risk is owned by the business – and, in the views of many, ultimately the CEO – the board's "essential oversight role," according to the Institute of International Finance (IIF), includes actively "review[ing] with senior management how the firm's

¹² US Department of the Treasury, "Secretary Geithner introduces Financial Stability Plan," press release, February 10, 2009. Available at <http://www.treas.gov/press/releases/tg18.htm>.

¹³ Lloyd Blankfein, "Do not destroy the essential catalyst of risk," *Financial Times*, February 8, 2009. Available at <http://www.ft.com/cms/s/0/0a0f1132-f600-11dd-a9ed-0000779fd2ac.html>.

¹⁴ Financial Services Authority, *The Turner Review: a regulatory response to the global banking crisis*, 93.

¹⁵ Hector Sants, "The regulator's role in judging competence."

strategy is evolving over time, and when and to what extent the firm is deviating from that strategy.”¹⁶ One executive summed up the views of numerous research participants, noting, “*There is a general sense that [directors] weren’t asking the right questions or getting the right information ... Directors failed in their risk oversight responsibility.*”

Proposals for enhanced risk governance

- Establish a risk committee of the board and ensure that the risk and compensation committees include a minimum number of risk experts (cf. financial experts on the audit committee)
- Encourage the risk committee to use independent risk advisers (cf. compensation consultants for the compensation committee) and have the chief risk officer report to both the CEO and the risk committee
- Perform an annual risk audit under the oversight of the risk committee
- Include a report from the risk committee in the proxy (cf. compensation discussion and analysis from the compensation committee) and deliver specific reports to regulatory authorities (including, perhaps, the risk audit results – filed confidentially)
- Implement ongoing director education, including field visits, focused on risk issues

Boards need to ensure risk appetite is more clearly defined and better understood throughout the organization

There is clear consensus that boards and management did not fully appreciate the overall level of risk facing their institutions. As a result, numerous reports have called for boards to become more actively involved in affirming and monitoring the firm’s risk appetite.

The IIF recommends that boards “review and periodically affirm the firm’s risk appetite” as well as monitor the firm’s “ongoing performance against its established risk appetite.”¹⁷ Several participants suggested the board’s involvement should go even further. One director remarked, “[T]he board risk committee needs to be deeply involved in shaping the risk profile of the [firm]; then it can be cascaded down [in the organization].” This accords with the Basel Committee’s statement that “it is the responsibility of the board of directors and senior management to define the institution’s risk appetite ... [and they] ... must first have an understanding of risk exposures on a firm-wide basis.”¹⁸

¹⁶ Institute of International Finance, *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations* (Washington, DC: Institute of International Finance, 2008), 36. Available at <http://www.ieco.clarin.com/2008/07/17/iff.pdf>.

¹⁷ *Ibid.*, 39–40.

¹⁸ Basel Committee on Banking Supervision, *Proposed enhancements to the Basel II framework* (Basel: Basel Committee on Banking Supervision, 2009), 13. Available at <http://www.bis.org/publ/bcbs150.pdf?noframes=1>, 13.

Risk professionals interviewed for this report stated unanimously that defining, measuring, and monitoring risk appetite is one of the greatest challenges FIs face as they come out of the crisis. One key issue is determining whether risk limits are “*hard or soft*,” as one participant put it. Once limits are adopted, it is important to know “*who can override the limits, if anyone*.”

Boards need a greater level of risk expertise

In its January 2009 report, the G30 recommended that boards be “up to the task of overseeing the complexities of modern risk management ... [B]oards must be populated with sufficient expertise to absorb such information and act on it.”¹⁹ One participant stated bluntly, “*Board members have a limited technical understanding of the risk issues*.” Another asserted, “*I’m not sure how directors can help banks unless boards are filled with people who understand the business*,” including risk matters.

Currently, expertise in risk varies substantially from board to board. Some boards (e.g., Credit Suisse) include a substantial number of former bankers and economists, who are thoroughly steeped in the details of risk management. Others (e.g., JPMorgan Chase, Wells Fargo) include few or no such experts, preferring board members with experience in large, complex organizations.

Regulators are certainly pushing for more expertise. The FSA has started to vet directors being considered for bank boards more aggressively, with a clear view to bolstering experience, and the US government’s behind-the-scenes influence at major US banks (e.g., Bank of America, Citigroup) has also suggested a strong bias toward appointing board members with ample sector experience. Key positions, such as the chairman, lead directors, and committee chairs, are clearly in their sights. Investors are also placing more emphasis on relevant director experience; as one leading European institutional investor put it, “*I’d take competence over independence any day*.”

Questions for directors:

- ? With respect to risk matters, where does the board’s responsibility start and stop relative to management’s responsibility?
- ? Within the board, how will risk responsibilities be allocated among the risk committee, other key committees (e.g., audit, compensation), and the full board? What needs to be done to ensure a comprehensive, enterprise-wide understanding of the key risks confronting the organization?
- ? How will a greater focus on risk tolerance affect core strategy and business model decisions?
- ? What is the optimal balance between technical expertise and broad-gauged business experience when constructing a board?

¹⁹ Group of Thirty (G30), *Financial Reform: A Framework for Stability* (Washington, DC: Group of Thirty, 2009), 40. Available at <http://www.group30.org/pubs/recommendations.pdf>.

2. Adopting compensation principles that discourage inappropriate risk taking

Powerful incentive plans do indeed motivate behavior. From the very outset of the crisis, observers blamed excessive risk taking on the structure of executive compensation plans. The issue has been exacerbated by the general public's disgust at the exceptionally high pay levels in the finance sector. Statements by world leaders such as Presidents Obama and Sarkozy, Prime Minister Brown, and Chancellor Merkel, and countless parliamentary and congressional hearings, all highlight that outrage.

All participants in this research acknowledge that the issue of compensation *"is front and center across the board and isn't going away."* One participant noted, *"The taxpayer – via politicians – will be much more critical of high pay."* Policymakers are interested in exerting direct influence over pay.

The Financial Stability Forum (FSF) – now Financial Stability Board – stated in its report on compensation, "Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms."²⁰ The G-20 endorsed the FSF's new principles on pay and are committed to implementing them, and the FSA and European Commission both issued recommendations on financial institution compensation.²¹ National legislatures have also been pressing for changes to pay practices.²² Many FI directors also point to the inclusion of executive pay restrictions in the US Troubled Assets Relief Program. As one director put it, *"Now [that] government money is involved, we will have to change the way we pay people."* See "Proposals for structuring executive compensation" on page 10.

FI leaders are deeply concerned about the harmful effects these restrictions will have on retaining and attracting top talent. The flexibility to design pay packages is being greatly constrained, and inconsistencies between regulators' proposals is making it significantly more complex to design pay programs. One participant said, *"If the products become commoditized, you don't need to pay for top talent. On top of that, politicians will not allow high pay. [In the] long term, that creates a major talent problem that no one is talking about."*

²⁰ Financial Stability Forum, *Principles for Sound Compensation Practices* (Basel: Financial Stability Forum, 2009), 1. Available at http://www.financialstabilityboard.org/publications/r_0904b.pdf.

²¹ The G-20 gave its endorsement in G-20, "The Global Plan for Recovery and Reform," communiqué, April 2, 2009, 3, available at <http://www.g20.org/Documents/final-communique.pdf>, and the FSA's recommendations can be found in Financial Services Authority, *Reforming remuneration practices in financial services* (London: Financial Services Authority, 2009), available at http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf. The European Commission's recommendations are detailed in Commission of the European Communities, "Financial services sector pay: Commission sets out principles on remuneration of risk-taking staff in financial institutions," press release, April 29, 2009, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/674&format=HTML&aged=0&language=EN&guiLanguage=en>.

²² Moves are afoot in both Germany and Switzerland. See Bertrand Benoit, "Germany gets tough on executive pay," *Financial Times*, May 29, 2009, available at <http://www.ft.com/cms/s/0/2b08297a-4c57-11de-a6c5-00144feabdc0.html>, and Heidi Lees-Bell, "Swiss watchdog curbs banking bonuses," *Institute of Commercial Management News*, June 4, 2009, available at <http://news.icm.ac.uk/business/swiss-watchdog-curbs-banking-bonuses/1937/>.

Whether or not FIs have accepted government funds, compensation disclosure requirements are likely to increase. In the United States, the Treasury and Securities and Exchange Commission (SEC) have signaled their intent to compel companies to explain clearly how compensation arrangements are consistent with promoting sound risk management and to provide more detail of pay approaches below the senior ranks.²³ In Europe, the European Commission has called for enhanced disclosures, with Germany leading the charge in this regard.

Directors recognize that they must address the compensation issue quickly: *“Boards will have to fix the problem. If we don’t, we’ll regret it.”* Boards also recognize they will need to review pay practices below the executive level. As one director observed, *“The issues go down to the coal face,”* which means that any solution will likely require consideration of how to pay not only senior executives, but also bankers and credit and underwriting professionals. As one regulator put it, *“We know in the past, professionals were paid \$50 million for a \$50 billion deal, regardless of how the deal turned out in the end. That won’t happen again.”*

Proposals for structuring executive compensation²⁴

- More informed, independent board-level oversight of executive pay
- Input from risk management and compliance to the compensation committee, with remuneration for risk and compliance personnel set independent of business areas
- Profit-based, risk-adjusted bonuses, where “performance” means long-term performance, through the cycle
- Risk-adjusted performance metrics, to mitigate incentives to manage earnings per share (EPS) or total shareholder return (TSR), with non-financial performance metrics forming a significant part of the assessment process
- No bonus potential in poor years, encouraging a higher fixed portion of compensation²⁵
- Deferred bonuses, where bonuses are a significant fraction of the fixed component, with bonuses linked to future performance of the firm

²³ See US Department of the Treasury, “Treasury Announces New Restrictions on Compensation,” press release, February 4, 2009, available at <http://www.treasury.gov/press/releases/tg15.htm>, and SEC secretary Mary Schapiro’s address to the Council of Institutional Investors, Washington, DC, April 6, 2009, available at <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.

²⁴ Drawn from Financial Services Authority, *Reforming remuneration practices in financial services*, and Goldman Sachs’s compensation principles, which are available at <http://www2.goldmansachs.com/our-firm/investors/corporate-governance/corporate-governance-documents/compensation-doc.pdf>.

²⁵ Morgan Stanley and UBS have already announced salary increases. See Rob Cox and Richard Beales, “Getting Around Smaller Bonuses,” *New York Times*, May 25, 2009. Available at http://www.nytimes.com/2009/05/26/business/26views.html?_r=1&ref=business.

Questions for directors:

- ? How should the board ensure that oversight of risk and reward are coordinated effectively?
- ? How can the board determine whether sound risk management is embodied in the firm's executive pay approach?
- ? Practically speaking, how can financial institutions ensure pay is risk adjusted?
- ? How will the compensation committee engage outside stakeholders – in particular, investors and regulators – in the pay-setting process?

3. Reshaping board organization and operations

In considering the future of board operations, the G30 summarized the views of numerous stakeholders when it acknowledged the need for “greater engagement of independent members having financial industry and risk management expertise.”²⁶ Most research participants agree there is no one-size-fits-all answer or “*prescriptive solution*” when it comes to board governance. That said, participants identified a number of baseline expectations that they believe all FIs will need to meet in the future: See “Additional proposals for board organization and operations” on page 12-13.

- **Unequivocal independence from management.** Independence means that management is accountable to the board, the board sets its own agenda and operating parameters, nomination and vetting of directors is handled by non-executive directors without undue management influence, and dissent is seen as appropriate. The notion of separating the roles of board chairman and CEO is a “*lightning rod for corporate governance activists,*” noted one director. Many analysts believe splitting the roles is an essential component of an independent board. Others argue that the split role enhances corporate performance, but this remains debatable. For certain, as boards have learned in the United Kingdom and Canada, making such a change materially alters board-management dynamics. In the end, as one participant put it, “*How a board behaves vis-à-vis management and each other is the issue,*” and boards will need to clearly demonstrate their independence regardless of formal structure.
- **Greater financial services expertise.** As noted above, critics claim that the current crisis has shown that bank boards have limited understanding of their business. One participant remarked caustically, “*A big issue for boards of these firms is to persuade themselves and others [that] they actually have a clue [about] what’s going on in their organizations.*” Another participant complained that bank board members “*either don’t really understand the issues, so they ask naive questions, or they are too involved and ask arcane questions.*” One participant suggested that board composition “*will have to change radically so there are people on the boards that understand financial services.*”

²⁶ Group of Thirty, *Financial Reform: A Framework for Stability*, 41.

On the other side of this debate, one director noted that it was the board members without deep financial industry expertise who asked the most probing questions about leverage and capital adequacy before the crisis hit. Another suggested that finance experts can sometimes exhibit groupthink.

Some believe that government's ownership stake in FIs is already precipitating in compositional changes that favor more sector experience; and this seems already to be happening at Citigroup and Bank of America. However, some participants note that the sector experience should be reflective of organizations of similar complexity and size.

- **Deeper engagement.** Research participants are aware that boards will inevitably have to get more involved in their businesses. Mr. Sants made this clear in a recent speech, stating that “market events support the view that non-executives, in particular, must play a greater role in the oversight of executive management.”²⁷ One former Wall Street executive stated, *“In recent years, boards [got more involved] ... But if in recent years we moved down to 10,000 feet, we may need to be at the 2,500-foot level in the future. Boards will have to get more involved in the weeds.”* Another participant agreed, saying, *“It may be that we need to stick our noses in more, regardless of management’s view.”* A third asserted, *“[Boards need to] look at decisions, business plans, where the company is allocating capital – input from a tactical as well as a strategic perspective.”*

Directors know it will be difficult to strike the right balance between raising levels of engagement and involvement and avoiding trespassing into management terrain, but they are persevering in seeking nuanced solutions. Several former and current FI directors believe more thought should be given to designing specific “forums for dissent” or other mechanisms through which constructive debate is encouraged.

Additional proposals for board organization and operations

- Split the role of board chairman and CEO, where this is not already the case
- Enhance performance evaluations of the board, its committees, and individual directors, particularly the chairman/lead director and committee chairs, and share the broad outputs of these evaluations with regulators and shareholders
- Ensure committees have adequate opportunity for cross-committee discussion and representation (e.g., overlapping membership on the audit, remuneration, and risk committees)
- Consider long tenure a threat to independence; ensure a mix of tenures on the board

²⁷ Hector Sants, “The Crisis: the role of investors.”

Additional proposals for board organization and operations *continued*

- Encourage members to gain an independent perspective on matters pertaining to the company, its industry, and key issues such as risk and compensation via outside advisers and other non-management sources
- Encourage board members to spend time with important company executives in their own environment, to probe for information and gain an understanding of the individuals
- Provide general staff support to board members, independent of management
- Pay board members commensurately with their responsibility and time commitment, with a mix of cash and restricted shares (to be held through retirement)

Questions for directors:

- ? What are the hallmarks of director independence? How should board members develop independent perspectives on the company, sector, and shareholder expectations?
- ? To what extent can improvement in board governance be achieved via process and structural changes, and how much depends on personalities and culture? How do you create an environment that encourages healthy dissent?

4. Increasing engagement with regulators and long-term shareholders

Research participants anticipate much more interaction between non-executive directors and key external constituents – notably key regulators and long-term shareholders. The veil surrounding boardroom decision making will likely be lifted, revealing board-management dynamics to those outside. This presents opportunities and challenges to FI boards.

More proactive regulatory outreach

Traditionally, director-level interactions with regulators have involved non-executive chairmen, where they exist, and audit chairs. For larger firms, regulators may also have held audience with the full board or audit committee periodically. For the most part, these interactions did not allow regulators to get a sense of the effectiveness of the board or how well it fulfilled its management oversight responsibilities.

Those days are gone. Regulators are seeking a window into board decision making and board/management dynamics. As one regulator put it, *“If one looks at Countrywide [Financial], it’s not clear that anyone ever asked management, ‘What if the securitization market dries up?’ Similarly, the quality of those types of discussions at Northern Rock is highly questionable.”* That regulator continued, *“We expect to spend much more time with directors. Not just audit chairs, but [also] the full board and members of the compensation and risk committees.”*

Regulators will be keenly interested in board-level oversight of risk, particularly as FIs significantly overhaul their risk management structures, personnel, and policies. They may wish to evaluate how boards are using external advisers in performing their duties. They may also seek insight into changing pay practices, although several participants feel that regulators “*will be uneasy about getting involved in setting pay.*” One said, “*Anyone who has been involved in setting pay knows it’s a nightmare.*” However, this participant suggested that “*regulators would want the private sector to take the lead, albeit they may want to influence or have input into the approach.*”

More discussions with long-term shareholders

The financial and economic crisis has raised questions about how well directors have fulfilled their responsibilities to investors. Mary Schapiro, chair of the SEC, recently noted, “[The] crisis has led many to raise serious questions and concerns about the accountability and responsiveness of some companies and boards of directors, to the interests of shareholders. These concerns have included questions about whether Boards are exercising appropriate oversight of management, [and] whether Boards are appropriately focused on shareholder interests.”²⁸

At the same time, Mr. Sants admonished institutional shareholders to shoulder their responsibility to engage with management: “Take responsibility to be active individually and more importantly, in collaboration with other investors, to engage with senior management and non-executive directors in companies and question the effectiveness of the construct of their boards.”²⁹

For their part, policymakers are proposing mechanisms to enhance board accountability to investors, whether through proxy access (in the United States) or enhanced board-shareholder interactions (in the United Kingdom). In the United States, direct communication between board members and shareholders has been relatively rare. While management (typically the CEO and CFO) make it a priority to communicate with shareholders, US board members have generally been discouraged from doing so for a variety of cogent reasons. Say on pay, which would give shareholders the right to cast an advisory vote on executive compensation arrangements, is actually intended to promote communication before the fact between the compensation committee and shareholders. In the United Kingdom, where institutional investors routinely meet with non-executive board members, there are concerns that these interactions have been far from optimal.

Conversations with the senior executives of major institutional investor organizations in Europe and North America highlighted several important takeaways for board members:

- **Investors expect, but fear, increased regulation.** Institutional investors anticipate an intense wave of regulation in the United States, which they foresee will include majority voting, proxy access, and say on pay. One shareholder described those provisions collectively as “*the biggest experiment in the history of corporate governance.*”

Institutional investors are concerned that some new regulations may constitute a knee-jerk

²⁸ Mary Schapiro, “Statement on Facilitating Shareholder Director Nominations.” Speech to the SEC open meeting, May 20, 2009. Available at <http://www.sec.gov/news/speech/2009/spch052009ms.htm>.

²⁹ Hector Sants, “The Crisis: the role of investors.”

reaction to the crisis: *“Transparency and accountability are better than prescriptive and restrictive regulation,”* said one investor. Another noted, *“You can almost take regulators out of the picture if you have a thoughtful, active board.”*

- **Investors recognize that with rights come significant responsibilities.** One investor commented, *“Shareholder rights aren’t a panacea, and the time and resource commitments are huge.”* Several of those with whom we spoke questioned whether institutional shareholders will have the resources and ability to be able to exercise their expanded rights.
- **Investors will seek greater communication with directors.** Long-term investors are insistent in their demands for increased interaction with directors. They believe that directors’ openness to dialogue will help to mitigate the *“pent-up rage”* among investors and the public. Moreover, added one institutional shareholder, *“listening to investors provides [board members] with an independent point of view on the company that can help them identify questions to raise with management.”* Additionally, cultivating relationships with long-term investors will help to create a shared understanding of the institution’s strategy. One shareholder acknowledged, *“We hook up with [activists] to get rid of ossified management or boards.”* He went on to say, *“If management had a long-term strategic plan that made sense, we’d be supportive,”* and would have less motivation to support activists’ agendas.

Directors point out that to some extent, shareholder pressure played a role in banks’ drive for growth and returns in the years preceding the crisis. They believe investors must address this issue as part of any comprehensive solution. Directors would greatly value candid dialogue with long-term investors on potential routes to sustainable growth.

Questions for directors:

- ? How will the nature of director interactions with regulators evolve? Will a broader set of directors engage in such discussions? What can boards gain from deeper discussions with regulators?
- ? How will the board interact with institutional investors? Is this interaction the job of the chairman or lead director only, or should other key committee chairs be involved? What are the respective roles of the board and management in interacting with these investors?
- ? To what extent should boards engage with other investors (e.g., debt holders and government investors)?

Conclusion

FI boards and management teams remain under intense scrutiny. Several research participants with whom Tapestry Networks spoke warned that there will be a *“search for the guilty”* that will target board members. A regulatory legal expert whom Tapestry Networks interviewed predicted, *“We will see a spate of subpoenas being issued over the next six months.”*

Directors of financial institutions are keenly aware of these pressures. They take some solace from the fact that the prevailing thinking recognizes that board governance played a relatively small role in the crisis compared with other factors. But they recognize that politicians and regulators – and to a lesser extent, investors – are calling for potentially radical reforms, regardless of the board’s role in the past. The room to maneuver in deciding between improvement or more far-reaching reform may be narrowing, with a regulatory bias in the United States and Europe clearly trending toward the latter.

In that context, although each institution’s path forward will be unique, directors believe that their firms, and their industry, will benefit greatly if board members can learn from and listen to one another, and to key stakeholders.

To support directors in this effort, Tapestry Networks, in partnership with Ernst & Young, has initiated the Financial Institution Directors Summit. The Summit is described in the Appendix.

15 June 2009

Appendix: Financial Institution Directors Summit Fact Sheet

Concept

The Financial Institution Directors Summit (the Summit) will bring together board directors from 12 to 14 major North American and European financial institutions (FIs) to share perspectives on strengthening corporate governance. These peer-to-peer discussions will be informed by prior interviews with FI directors, executives, stakeholders, and experts documented in a series of white papers.

Directors invited to participate in the Summit will play a critical leadership role on the board of their financial institutions including non-executive chairmen, lead directors, and key committee chairs.

At the Summit, the directors will debate possible changes to FI corporate governance and discuss practical proposals for implementation. Armed with these insights and perspectives, they will be prepared to take the lead in discussing and designing changes to their own board's approaches to governance.

Context

In the wake of the financial system and economic crisis, the global banking industry finds itself at the dawn of a new era and in the midst of unprecedented change. Public policy and individual firm initiatives have naturally focused, up until now, on two priorities: (1) restarting the global economy and (2) instituting regulatory reform aimed at preventing a recurrence of the current crisis.

While corporate governance, and specifically the role of the board of directors, is seldom cited as a leading cause of the crisis, board directors do feel a keen sense of responsibility and an urgent desire to help engineer whatever changes may be warranted. The directors of leading FIs seek a vehicle through which they can engage with peers and stakeholders to address the challenges of bank governance in the new era and lead governance reform initiatives on their own boards.

Organizers

The Summit is organized and led by Tapestry Networks and supported by Ernst & Young. Tapestry Networks is a leader in corporate governance peer networks. Its mission is to foster relationships, insight, and courage to inspire and enable leaders to act. Ernst & Young is a global leader in assurance and risk management services to FIs.

Participants

Participation in the Summit is by invitation only. Criteria for participating institutions include:

- Complex, global footprint
- Large capital markets operations
- Significant interest in US and UK regulatory reform
- Leading recipients of government funding infusions and support

One or two directors from each FI may participate. Each participant will be nominated by the board and CEO of the institution.

Potential topics

Initial conversations with FI directors indicate a strong interest in examining the following areas of board oversight and governance:

- Evolving expectations for FI boards
- The changing face of risk management and oversight
- New approaches to executive compensation
- New standards for board organization and operations
- Engagement with regulators and long-term shareholders

Tapestry Networks will work with participants to refine the proposed topics. Prior to the Summit, participants will receive white papers on each major discussion topic.

Participant value

We seek participants who seek to learn and commit to lead their boards toward corporate governance arrangements suited to the new era. They will gain the insights, conviction, and courage necessary for effective leadership through:

- Private peer-to-peer dialogue to develop practical insights on issues confronting FI boards of directors
- Personal and professional relationship-building with FI board leaders from global institutions
- Access to cutting-edge insights and perspectives from external constituents such as regulatory officials, risk and compensation experts, and key policy influencers
- Contribution to rebuilding public trust in financial institutions

Expected time commitment

FI member institutions will commit:

- One or two directors to participate in a 90-minute pre-meeting conversation with members of Tapestry Networks and Ernst & Young to shape the Summit's agenda and discussion topics
- One or two directors to attend the Financial Institution Directors Summit, a one and a half day time commitment, in October 2009, to be held in New York
- One or two directors to participate in 90-minute discussions with the FI's CEO and CRO in advance of the Summit

Confidentiality

The Summit will use a modified version of the Chatham House Rule whereby names of participants and their company affiliations are a matter of public record but comments made during interviews and meetings are not attributable to individuals.

Insights developed from the Summit initiative will be published by Tapestry Networks and may then be distributed by Summit participants to colleagues. They will also be distributed by Ernst & Young to its partners and clients.

Disclaimers will appear on all materials stating, *"The views expressed in the Summit materials represent the personal views of the participants. They do not reflect the views nor constitute advice of the participants' organizations, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice."*

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