

# Bank Governance Leadership Network

## Insights from the non-executive director dinners

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## Risk appetite, strategy, and regulatory reform

### The role of the board and the challenges of regulation

In 2009, Tapestry Networks and Ernst & Young launched an initiative that brought together directors and executives from leading banks to discuss the board governance and risk oversight challenges confronting them and their institutions. Eighteen directors from 11 European and North American institutions met in New York in October 2009, where they agreed that they have a central role to play in rebuilding trust in the industry and in working with management and key external stakeholders to build a sustainable future for their institutions.<sup>1</sup>

Since October, the dialogue among directors and executives, as well as key regulators and opinion formers, has continued.<sup>2</sup> In April and May, Tapestry and Ernst & Young convened two groups of non-executive directors for discussions on the present challenges facing bank boards. The first was held on April 26 in New York; Brian Peters, the senior vice president for risk management at the Federal Reserve Bank of New York, attended that meeting as a guest. The second was held in London on May 17 and Sally Dewar, the managing director for risk at the Financial Services Authority, joined as a guest. [See “About this document” \(page 12\) for more on the research and the appendix \(page 13\) for a list of the participants and the organizations they represent.](#)

The discussions covered a wide range of topics and surfaced important insights and perspectives – in some areas divergent and in others quite uniform. Four themes emerged from the two discussions:<sup>3</sup>

#### 1. **The role of the bank board is ambiguous** *(Page 2)*

Participants described a wide range of philosophies and practices with respect to how boards around the globe carry out their legal and fiduciary responsibilities. Does the board direct, manage, and control management, or does it oversee management and exercise duty-of-care responsibilities? What is the relationship between good governance and good judgment?

#### 2. **The practical definition of “risk appetite” is hard to pin down, but the need to link risk and strategy is broadly recognized** *(Page 4)*

Risk oversight is widely acknowledged as a vital task for bank management teams and boards, and risk appetite is the centerpiece concept. Regulators demand a robust discussion about risk appetite, but define it only in general terms. Board risk committees focus on defining, describing, and assessing it, but there are few signs of convergence across the industry on a common definition or on approaches for measuring risk appetite.

<sup>1</sup>The four *ViewPoints* documents generated by the Financial Institution Directors Summit are available as a single report, entitled [Invigorating bank governance in a new era](#) (Ernst & Young and Tapestry Networks, 2009).

<sup>2</sup>We have spoken with over 60 bank board members and senior bank executives, including chief risk officers, since October 2009.

<sup>3</sup>All Tapestry discussions are held under Chatham House Rule, whereby remarks are not attributed to individuals or institutions. This encourages candor and permits broad sharing of ideas and insights. However, Ms. Dewar and Mr. Peters have given permission for their remarks to be attributed. The quotes in italics are from discussion participants.

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The director discussions highlighted the importance of characterizing each constituent business or major product in terms of risk and profitability and in terms of its capital, liquidity, and cash requirements – and then aggregating these parameters across the portfolio. This analysis yields an economic “*picture of the bank*” that can be studied and debated. Under this approach, risk appetite emerges as the keystone of the bank’s strategy.

### 3. Risk governance remains a challenge *(Page 6)*

While acknowledging the benefits of recent investments in detailed risk management techniques, directors and regulators now firmly recognize that judgment trumps science. Stress testing and scenario planning are certainly useful tools when they are used to spark a dialogue about management’s key assumptions about future performance. As for predicting the future, directors have a healthy skepticism and recognize that the models are woefully unreliable in that regard. Directors are improving risk governance through the diligent work of their risk committees and improved risk reporting.

### 4. The evolving regulatory environment presents opportunities as well as challenges *(Page 9)*

The regulatory environment is a jumble of overlapping and conflicting proposals. The industry and its regulators are hampered by the lack of common capital and global accounting standards. Global harmonization is unlikely. The pace of change, driven in part by political forces, may be outstripping anyone’s ability to gauge the aggregated impact of new costs and constraints. Directors are very worried that the aggregate impact of these proposals will place a far greater burden on the global economy and bank performance than imagined. Yet, directors believe regulators may be an important buffer from political interference and welcome signs that regulators are open to dialogue.

## The role of the bank board is ambiguous

Board members and regulators remain unclear about the role and responsibility of bank boards and the individual non-executive directors who comprise them. Much hinges on how responsibility for bank performance, including the failure of banks, is assigned: a board that holds itself accountable for performance may decide to carry out its responsibilities differently than a board that sees its role as principally one of oversight and stewardship. Two stories, one from a legal perspective and one from the board’s perspective, illustrate the debate under way:

### A legal perspective

At the New York director dinner, Mr. Peters commented on the March 2010 Valukas report on the bankruptcy of Lehman Brothers.<sup>4</sup> He noted that Mr. Valukas could not find colorable claims against either management or the directors under Delaware law. This led Mr. Peters to ask what, exactly, the

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<sup>4</sup> See Anton Valukas, [Report of the Examiner in the Chapter 11 proceedings of Lehman Brothers Holdings Inc.](#) (Chicago: Jenner & Block, 2010).

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responsibilities of the board were and who should be held accountable in cases such as the Lehman bankruptcy. His research turned up contradictory evidence:

- Delaware law, the Combined Code of the UK's Financial Reporting Council, and the bylaws of banks' articles of incorporation indicate that boards should “manage, direct, lead, and control the actions of management.”
- The American Law Institute's *Principles of Corporate Governance*, on the other hand, state that “although the statutes literally seem to require the board either to manage or direct the management of the corporation, it is widely held that the board of a publically held corporation normally cannot and does not perform those functions.”<sup>5</sup>

Mr. Peters concluded, therefore, that practitioners believe the true role of the US and UK board is to oversee rather than to direct. This is the interpretation of most non-executive directors with whom we have spoken. They carefully respect the line between management's responsibility to produce and execute plans and the board's responsibility to oversee and approve. Yet, Mr. Peters noted that US and UK regulators are pushing boards back toward their legal duties as originally written: more direction than oversight.

Participants in the London dinner, reflecting on the distinction between direction and oversight, noted that the situation becomes even more complex when one looks beyond the United States and the United Kingdom. In other jurisdictions, the roles and accountability of management and board members can be quite different. In jurisdictions influenced by the original Code Napoléon, for example, board members are personally accountable for the conduct and performance of the business – that is, the standard for accountability goes well beyond the duty-of-care benchmark. In the Anglo-Saxon countries, and particularly under a two-tier board arrangement such as that practiced in Germany, by contrast, management is accountable and boards play a more supervisory role.

### **The board perspective**

The chairman of a large bank that did not fare well in the crisis commissioned a detailed review to uncover what went wrong. The review determined that the bank and its board of directors had been entirely diligent. Board members were distinguished and successful businesspeople; the board met regularly; committees were chartered correctly and functioned well; board members asked good questions; management had provided all pertinent information; and special studies had even been commissioned to probe deeply into assets about which the board was uncertain.

The review concluded that there was not a failure of governance – indeed everything was done just as it should have been – even if there was without doubt a failure of judgment. Management, with the oversight and concurrence of the board, simply misjudged the riskiness of the bank's strategy and positions. When the global economy crashed, the bank was ruined, its shareholders wiped out, and enormous collateral damage suffered by creditors and customers.

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<sup>5</sup> American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, (Philadelphia: American Law Institute, 1992), 3.02.

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So what is the relationship between good governance and good judgment? Participants in the Bank Governance Leadership Network believe that good governance is not primarily about conformance to a set procedure or compliance with a set rule. It is precisely about the arrangements that yield good judgment. As one director put it, *“Let us define how to [operate] ... How we execute should be our own affair, and then hold us accountable.”* But what do boards and board members need to do to assure they exercise the best judgment possible?

Questions for directors:

- ❓ How can the board define the boundaries of active engagement such that it doesn't cross the line into management's role on key issues, such as risk governance?
- ❓ Irrespective of its legally defined responsibilities, does your board feel accountable for firm performance or only for effective oversight of management?

### **The practical definition of “risk appetite” is hard to pin down, but the need to link risk and strategy is broadly recognized**

One area in which all parties would like to nail down the appropriate role of the board is in determining an appropriate risk appetite for the bank. Participants at the dinners say their firms are seeking to address this question first by defining and characterizing risk appetite and then by highlighting how best to tie risk appetite directly to firm strategy and capital planning.

### **Defining and characterizing “risk appetite” remains a vexing challenge**

The term “risk appetite” rolls easily off the tongue, and it is even simple to define, at a high level. The UK's Financial Services Authority (FSA), for example, states, “Risk appetite is the amount of risk that one is prepared to accept, tolerate, or be exposed to at any point in time.”<sup>6</sup>

Easy to say, perhaps, but the idea is not so easy to translate into practice. One director, interviewed prior to the dinners, may have said it best: *“People know risk appetite is important, and they think they've got it. But the industry is still falling short on how to think about it. We don't have a paradigm yet.”* Other directors at the dinners agreed. As one put it, *“Our challenge as non-executives is there is no definition. We are dealing with words, not well-understood and agreed concepts.”* Moreover, added another, *“There's no ‘hitchhikers' guide' to risk appetite, and no agreement there should be one.”*

Directors at both dinners pressed the regulators for some clarity on what, concretely, their role vis-à-vis risk appetite should be. Mr. Peters gave a broad response: “Directors need to provide management with parameters – define the box management will operate in.” At the London dinner, one director asked Ms. Dewar to define risk appetite. She responded, “There is no single definition of risk appetite, nor should there be. Each bank has a unique set of circumstances and mitigating factors.”

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<sup>6</sup> Financial Services Authority, [The FSA's risk-assessment framework](#) (London: Financial Services Authority, 2006), 68.

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Given this lack of specific, concrete guidance from regulators, banks have had to create their own definitions and approaches. Non-executive directors in New York and London shared a variety of ways in which they describe risk appetite:

- Some use a table that lists the bank's primary businesses and products. Each of these has a hard limit on exposure. Exceeding those limits, presumably, requires executive or board authority.
- Others focus on earnings at risk, defining how many quarters of earnings the board is willing to risk against a collection of possible outcomes.

Nonetheless, one director said prior to the dinners that even after spending time and resources defining and agreeing their firms' risk appetite, *"it will take us another two or three years before we have gotten this right."* In the short term, this means uncertainty remains in the boardroom. Asked whether all board members could give a reasonably accurate statement of their bank's risk appetite, one director said, *"I think members of the risk committee could do so."* Another commented, *"I would guess that half of the rest of the board, armed with a copy of the document that defines our risk appetite, could do so. The others might have a more difficult time."*

#### **Linking risk appetite to strategy is critical**

Directors at both dinners believed strongly that any discussion on the firm's risk position must be reviewed in the context of the firm's strategy. One director noted, *"Risk appetite really needs to be linked to either franchise or strategic positioning."* The dinner discussions supported the idea that a fruitful, meaningful discussion of risk appetite must:

- **Be built up from a business and product level.** One director observed, *"We are so focused on our institutions as a whole, but we need to spend more time understanding the parts of the business."* Another reinforced the point by noting that risk appetite *"must extend across all product lines."*
- **Link risk and reward.** Noted one director, *"We need to shift our focus and look at the risks the company is or should be taking in order to make money."* Another director urged, *"We need to focus more on the risk-reward trade-off, and we need to view that trade-off from several angles, notably from the perspectives of shareholders and customers. These perspectives may differ."*
- **Connect to the capital requirements of each business.** *"The real job is to build up the risk position of the bank, starting with each building block. 'Here is a picture of our business, with capital allocated accordingly,'"* noted one director. This accorded with another's view: *"Some businesses are inherently capital hogs. You have to stay with the process and then dig down further and be prepared to double-guess [i.e., challenge] management."* Another outlined his firm's approach: *"We decided to look at every business: what we did, and how much capital it consumed. This allowed us to evaluate if we were using the right amount of capital for the expected returns. We also moved out of some businesses, once we focused on overall capital allocation."*
- **Remain dynamic.** Another director pointed out that risk appetite must be dynamic – it does not remain static or fixed. *"Strategy by definition has a vector of movement in risk appetite. At any*

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*moment, you are in a position, and then there is a directional attribute of where you want to go. [Our bank] reduced its position in a certain set of exposures; you could infer this was a decline in risk appetite. But that was a diet, not a reduction in appetite.”* Similarly, another participant noted that “regulators seem to think it’s always a very bad thing when risk limits are exceeded, versus thinking of limits as [being] there to prompt dialogue between management and the board.”

Questions for directors:

- ❓ How should the board engage with management in setting and monitoring risk appetite?
- ❓ How is the firm’s risk appetite integrated into strategic planning and decision making at the board level and within the lines of business?
- ❓ How well do the non-executive directors understand the institution’s risk appetite and its impact on strategy and future returns?

### Risk governance remains a challenge

Directors at the dinner recognized that despite the challenges banks face in defining risk appetite and linking it to strategy, each of their institutions is actively working on improving risk oversight.

### Evaluating risk is an art, not a science

Richard J. Rosen and Carl Tannenbaum of the Federal Reserve Bank of Chicago recently published a paper, *The Art and Science of Risk Management*, which traces the history of risk management. They noted that as approaches to risk oversight moved from focusing mainly on credit risk to such concepts as value at risk (VaR) and economic capital (EC), boards may have gained a sense of false security, believing that those metrics could serve as effective measures of exposure and the basis for limit setting.<sup>7</sup>

Participants in the dinners no longer take such comfort in the “science.” One cited the “*illusion of spurious accuracy*” that comes with quantitative models. Another, describing the old approach to risk oversight, said, “*We met with smart people who had detailed models based on 30 years of historical data, yet even with such brains in the room, we had 17 one-in-a-hundred-years events in three months.*”

Now, boards have adopted a more balanced approach to risk oversight that aligns with the views of Messrs. Rosen and Tannenbaum, who concluded that “a balance [is] needed between statistical and intuitive perspectives of risk at financial firms,”<sup>8</sup> and that “risk management must combine art and science. While strongly informed by math and models, effective risk management ultimately relies on good judgment. Firms and their supervisors should seek to stress the importance of combining these perspectives.”<sup>9</sup>

One dinner participant gave a vivid example of judgment at work, summarizing his understanding of Emilio Botín’s three-part test for approving new products and services at Banco Santander.

<sup>7</sup> Richard J. Rosen and Carl Tannenbaum, *The Art and Science of Risk Management* (Chicago: Federal Reserve Bank of Chicago, 2010).

<sup>8</sup> Ibid., 7.

<sup>9</sup> Ibid., 13.

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Botín asks:

1. Do I understand what the product is and is supposed to do?
2. Would I buy this product if I were in the target market?
3. Should the bank put capital against this product/business, given its risk profile, profit potential, and capital requirements?

Botín's test is one that every bank director, irrespective of background, can apply. Importantly, it embodies a dual focus: the client and the bank.

### **Risk assessments must be forward looking**

While statistical and analytic progress will no doubt continue apace, board members are less than completely enthusiastic about diving deeper into the weeds of the bank's trading and asset positions, or understanding the intricacies of new models. They fear such efforts risk duplicating management's job of running the bank. There is, however, significant agreement that considerations of risk need to be made with a forward-looking approach. One director admitted, *"We're still spending too much time looking at the past."*

Directors consider stress tests and scenario plans to be effective tools for provoking quality discussion among the board and management about the future. Noted one director, *"The process of stress testing our organizations and the rigor required to raise capital in the markets has really helped non-executives understand their firms."* Another noted, *"Stress testing and scenario planning help identify the major fault lines – the key assumptions driving management's approach. With those brought out into the open, non-executive directors can discuss with management whether they are reasonable or not."* Ms. Dewar acknowledged that regulators, too, are learning a lot through the stress-testing process: *"We get a better sense of how the businesses make money and can see any differences between what we thought and what is actually happening."*

### **Getting a balanced risk oversight model is important**

After one of the dinners, a participant observed, *"Directors at different firms seem to be at different levels of engagement and involvement, and the level of knowledge varied quite a bit."* Dinner participants noted several factors that all firms should consider as they work to improve their risk oversight:

- **Getting the people balance right.** Bank boards have been urged to engage more deeply in risk governance and to populate the risk committee with individuals steeped in the science of risk assessment and metrics. Participants recognize the need for such expertise; indeed, one noted, *"Directors with no prior experience in financial services will be challenged. Even after five years on a bank board, they may still not know enough to be really effective."* At the same time, the benefits of wisdom and a willingness to argue contrary positions have never been greater. The challenge for boards and risk committees is to strike the right balance between technical know-how and judgment – in the best circumstances getting both in abundance. Warned one director, *"There is a real danger we have a two-speed board: those*

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*directors on boards that have financial services knowledge, and those that do not, and those on the risk committees and those that are not.”*

- **Gaining control of the agenda.** Several participants explained that the way their risk committee tackles its agenda has changed. Noted one, *“Building a risk committee takes time. Initially, management is really setting the agenda, because there is a catch-up process.”* Another director noted, *“We have now taken more control of the risk committee agenda. Annually, we ask management to suggest a calendar for the year, then we sit down as a committee and determine what we want to discuss ... This stopped management thinking that they set the agenda.”* One member stressed that the risk committee *“needs to be able to look both at overall risks and [also] do a deep dive into specifics (e.g., derivatives, business P&Ls). It’s very challenging.”*
- **Avoiding committee silos.** In general, directors are concerned that deeper engagement in the details of risk, audit, and executive compensation may result in silos within the board. Key committees are still seeking to define their roles more clearly – for example, what belongs in the charter of the audit committee and what in the risk committee? One director warned, *“It’s clear the board’s agenda is so big that division of labor makes sense, but how do we avoid silos?”* Reflecting the prevalent view at the table, one director said, *“I don’t want to make critical decisions in committee that are not understood and supported by the entire board.”* Regulators have been keen to push firms to establish separate risk committees. Those in favor of a risk committee agreed with one director who said, *“The audit committee can focus on the systems and processes, and major exposures, whereas the risk committee has more time to dig down deeper into the risks.”* Another noted, *“The risk committee is a different process for looking forward. It cannot be done by the audit committee, which is, by design, backward looking.”* Those arguing against a separate committee said that *“the audit committee cannot understand the balance sheet without having a good sense of the risks.”* One director also noted a practical challenge: small boards may find it hard to populate the risk committee.

#### **Effective board oversight requires good risk reporting**

Participants universally agreed that more needs to be done to improve risk reporting. One asked, *“What sort of reporting do you need to assess [risk]? Are non-executive directors able to properly understand and assess the reports?”*

Directors expressed concern that even though a bank’s risk report might *“pass the FSA’s ‘thud test’*” in terms of length and detail, it might not provide the insight everyone seeks. More broadly, one noted, *“I’m concerned we’re becoming even more checklist focused than before. We spend more and more time approving reports for regulators and not enough time talking with management about the business.”* They also noted that risk reports are not always directly aligned with the key risks highlighted by the chief risk officer in discussions with the board.

Others suggested that operational risks are often underreported, and systems may need to be upgraded to ensure the timeliness and quality of data. Mr. Peters remarked, *“As boards think about risk appetite, they also need to think about the quality of the infrastructure the firm needs in order to grow – especially IT. In*

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banks, the front office always has the latest and greatest, but the core infrastructure does not get the level of investment that is required.” In practice, participants agreed that both regulators and boards need to press management on this to ensure sustained investment over the next couple of years.

Questions for directors:

- ? What are the essential ingredients of an effective board-management dialogue on risk? Do the board and risk committee periodically evaluate how well they oversee risk?
- ? What board structures and practices result in the most effective risk oversight?
- ? What is the critical information boards need to effectively oversee risk? Are there additional external sources of information that could help improve risk oversight?
- ? What infrastructure challenges – for example, relating to IT or internal reporting systems – may hinder the institution’s oversight of risk? How is management addressing these challenges?

### The evolving regulatory environment presents opportunities as well as challenges

Bank directors have continually stressed their concern that the regulatory environment is changing too quickly, in too uncoordinated a fashion, and often with little public discussion on which changes are useful and which are unnecessary or even counterproductive. Yet at the same time, directors appreciate that regulators can serve as an important buffer between banks and opportunistic politicians, and directors feel that positive engagement with directors on emerging rules may be highly beneficial.

#### Lack of coordination and cost assessment is a problem

One director captured the sentiment of others in stating, “*There’s a huge danger that global regulators are simply trying to do too much all at once. There’s a risk that they won’t get the few critical things right.*” Indeed, directors at the dinners pointed to a number of challenges emerging from the rush to regulate:

- **Lack of coordination on approaches and definitions.** Directors reiterated a core message of the 2009 Financial Institution Directors Summit about the lack of effective cross-border cooperation among regulators: “*I don’t think we’ll get an international solution for some things.*” Several noted the fact regulators seem unable to agree on common definitions for critical terms: “*Even in Europe, there is no agreement on how to define capital. For example, there are different approaches to deferred tax assets ... differences that are more pronounced globally, since they are treated differently under US Generally Accepted Accounting Principles than under International Accounting Standards.*” Ms. Dewar conceded that this is a problem: “There are really challenges in agreeing and implementing consistent definitions, for example, the treatment of equity in tier one capital.”
- **No real debate on the broad effect of new regulation.** Directors continue to worry about the macroeconomic effect the new rules will have on banks. Several directors expressed concern that regulatory proposals seem targeted at “*creating smaller and simpler banks – but smaller and simpler doesn’t mean less risky.*” Mr. Peters acknowledged that capital adequacy rules alone “will change the

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economics of this business.” The majority view was that the impact will be significant: *“It will cost us a couple of points of GDP growth, and regulators aren’t accountable for this.”* However, several were more sanguine: *“I’m not sure there’ll be a different level of economic activity; it will just migrate out of the sector to unregulated areas.”* Participants in the London dinner were pleased to hear Ms. Dewar say, “Regulators are aware of the dangers of overlapping regulations. That’s why the FSA intends to conduct a prudential review of all new regulation, with a view to identifying where there will be overlap – and, importantly, inconsistencies – and where they are still gaps.”

#### **The board’s role in recovery-and-resolution plans is to focus on recovery**

Directors struggled with determining how regulators believe boards should be assessing recovery-and-resolution plans (“living wills”). Many said that it seems contrary to their role as stewards of the long-term success of their firms to focus on plans for winding down their firms in case of extreme stress. The regulatory guests at the two dinners had strong opinions on where boards should focus most attention:

- Mr. Peters stated, “Boards can’t define resolution, that’s the job of the regulators. The board should focus on recovery – how to build back the business.”
- Ms. Dewar stated, “At a high level, boards should focus most on the contingency plan element. It is important that boards and management can demonstrate that they know where their resources are and that they have a good sense of how they may ensure their firms recover, under three broad scenarios: the business model was defective, their risk management systems failed, or their firm (and others) suffered a significant exogenous shock.”

#### **Regulators can be a shield, and directors should engage them directly**

Even though directors have strong reservations about the fervor to regulate, they generally agree with the director who said, *“Regulators are under intense pressure. We need to recognize that. In some ways, they can be our shield, protecting us from politicians.”* But it is a fine line for regulators to walk: they need to be careful about *“getting involved in the management of the firms.”* One director suggested that regulators should focus on *“safety and soundness – leave the social policy to the politicians.”*

Both Mr. Peters and Ms. Dewar are open to dialogue. Mr. Peters stressed that “the Fed is always willing to have dialogue – formally and informally.” Similarly, in commenting on the need for open dialogue on new capital and liquidity rules, Ms. Dewar said, “It is important that firms simply recognize that the regulators’ objective is higher liquidity and capital. But firms can help us shape the actual requirements, if they engage with us.”

In practice, individual directors may not be able to avoid interacting with regulators. In comments to the City Corporate Governance and Remuneration Summit on March, 30, 2010, Ms. Dewar shared the FSA’s views on regulatory oversight of corporate governance: “We recognise that our regulatory approach before the crisis underestimated the importance of governance, but we are committed to putting that right ... We need to change the focus and look closer at behaviour and culture in firms, [including] ensuring ... that good

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culture and behaviours are being reinforced by effective corporate governance and the role of the boards.”<sup>10</sup> At the director dinner, Ms. Dewar highlighted that “the FSA is focusing more attention on our interactions with directors. In January, we issued our view that the audit and risk chairs should be considered ‘significant influence-controlled functions.’<sup>11</sup> This signals we want to be involved in their appointment, and we want to meet with them more, on an ongoing basis.”

### Regulators are pressuring boards to engage with shareholders

Participants at the London dinner engaged in lively discussion about the regulatory push to force bank boards to engage their shareholders more proactively. The Walker review – the most comprehensive review of bank governance in the post-crisis era – focused one of its seven chapters on the role of institutional investors.<sup>12</sup> As Ms. Dewar has stated publicly, the FSA “fully supports the objective of increasing shareholder engagement.”<sup>13</sup>

The opinions of participants at the London dinner ran the gamut:

- *“Shareholders were a significant guilty party ... Empowering [them] worries me. They forced us into this mess. Why would we give them the keys to the castle now?”*
- *“Shareholders simply wanted management to live up to the expectations that they had set for themselves. The problem is [that] management over-promised.”*
- *“At the end of the day, boards have to listen to their shareholders – and activist shareholders can have good perspectives. But, boards ultimately have to step back and make an independent decision for the long-term health of the company.”*

Questions for directors:

- ❓ How well do the board and management team understand the potential effects that proposed regulatory changes may have on the firm’s strategy?
- ❓ Should non-executive directors change the way they engage with regulators or shareholders, and if so, how? What are the potential benefits or risks of more engagement with these key stakeholders?

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Board members face a formidable challenge in exercising their responsibilities. Nowhere is the challenge more evident than in risk governance. Risk appetite is a pivotal concept without a common definition among banks or regulators. The job calls for both a degree of technical competence and a large measure of wisdom and judgment. Insight into risk appetite comes only when business-level risk is viewed in the

<sup>10</sup> Sally Dewar, “[Taking the FSA’s corporate governance agenda forward](#),” speech at the City Corporate Governance and Remuneration Summit, March 30, 2010.

<sup>11</sup> See Financial Services Authority, *Effective corporate governance (Significant influence controlled functions and the Walker review)* (London: Financial Services Authority, 2010).

<sup>12</sup> David Walker, *A review of corporate governance in UK banks and other financial industry entities* (London: HM Treasury, 2009).

<sup>13</sup> Sally Dewar, “[Taking the FSA’s corporate governance agenda forward](#).”

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context of profit potential and capital requirements, and the business perspectives are aggregated into a (portfolio) picture of bank strategy. The inescapable conclusion is that a serious discussion of risk appetite is tantamount to a discussion of bank strategy. The entire board needs to be involved at some level.

A common thread ran through the director discussions in both New York and London: directors are unequivocally committed to independent thought and action, and they are making a material difference to the debate and decisions taken inside the boardroom. More than ever in recent memory, the external and internal environments are fluid. Therefore the demands on the board are real-time and urgent. Non-executives see themselves as engaged partners with management – but as partners who set the agenda and reserve the right to disagree with and overrule management on occasion.

### About this document

The Bank Governance Leadership Network is a group of non-executive directors from North American and European financial institutions brought together to share perspectives on proposals for strengthening corporate governance. Their peer-to-peer discussions are informed by conversations with bank directors, executives, regulators, investors, and other key stakeholders. Tapestry Networks conducted the research, orchestrated the discussions, and prepared this memo. Ernst & Young sponsors the research as part of its deep, continuing commitment to board effectiveness and good governance.

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### Appendix: meeting participants

#### Participants at the April 26 meeting

- Carmine DiSibio, Vice Chair and Managing Partner, Financial Services, Ernst & Young
- Nicholas D. Le Pan, Risk Committee Chair, CIBC
- Brian M. Levitt, Corporate Governance Committee Member and Management Resources Committee Member, TD Bank
- Donald T. Nicolaisen, Audit Committee Member and Compensation, Management Development and Succession Committee Member, Morgan Stanley
- Brian Peters, Senior Vice President, Bank Supervision Group, Federal Reserve Bank of New York
- Donald E. Powell, Audit Committee Member, Compensation and Benefits Committee Member, Bank of America
- William Schlich, Industry Leader, Banking and Capital Markets, Financial Services, Ernst & Young
- David Sidwell, Risk Committee Chair, UBS
- Diana Taylor, Oversight Committee Member, Citigroup
- Donald T. Vangel, Advisor, Regulatory Affairs, Ernst & Young

#### Participants at the May 17 meeting

- Guido Celona, Senior Partner, Ernst & Young
- John D. Coombe, Independent Non-Executive Director, HSBC
- Sir Sandy Crombie, Senior Independent Non-Executive Director, RBS
- Sally Dewar, Managing Director, Risk, Financial Services Authority
- Patricia Jackson, Head of Prudential Advisory Practice, Ernst & Young
- Lord Alexander P. Leitch, Deputy Chairman, Risk Committee Oversight Chair, Lloyds Banking Group
- Andrew McIntyre, Senior Partner, Ernst & Young
- Nathalie Rachou, Audit, Internal Control, and Risk Committee Member, Société Générale
- Anton van Rossum, Risk Committee Member, Credit Suisse
- Anthony Wyand, Vice President of the Board, Audit Committee Chair, Société Générale; Deputy Chairman, Internal Control and Risks Committee Chair, UniCredit