

Bank Governance Leadership Network ViewPoints

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Global banking adapts to adverse economics and restrictive regulations

On September 26–27, Ernst & Young and Tapestry Networks welcomed 18 board members of global banking institutions to the third annual Bank Directors Summit in New York. Over the course of the summit, these non-executive directors¹ shared experiences and insights on the major challenges facing global banks.

Five distinguished guests joined us for part of the summit, bringing regulatory, CEO, and central bank perspectives. We remain grateful to our guests: Andrew Bailey, deputy head of the Prudential Business Unit, Financial Services Authority (FSA), United Kingdom; Sarah J. Dahlgren, executive vice president, financial institutions supervision group, Federal Reserve Bank of New York; Jamie Dimon, chief executive officer and chairman, JPMorgan Chase; Elizabeth A. Duke, member, Board of Governors of the Federal Reserve System, United States; and F. Edward Price, deputy superintendent, Office of the Superintendent of Financial Institutions, Canada.

Three years since the bleak days of the financial crisis, talk of a once-in-70-years depression may have passed, but major concerns persist about the short- and medium-term global economic outlook. Indeed, since the last summit, in fall 2010, the degree of uncertainty facing the industry has, if anything, increased:

- The European economy has stalled, with debt and budget crises bringing significant political challenges across the eurozone and beyond.
- The US economy has faltered, and the political stalemate over how to handle long-term debt and fiscal challenges has cost the country its much-prized S&P triple-A rating.
- Regulatory pressures have increased as regulators,² supervisors, and politicians have imposed more costly requirements on systemically important financial institutions (SIFIs). Hopes for globally standardized, coordinated regulations have faded as national pressures to protect local taxpayers have prevailed.
- The regulatory landscape is altering materially, with new agencies, mandates, and leadership.
- Changes in supervisory approaches have further pressured boards to challenge management in ways that may blur the lines between the board and management; supervisors, too, may be overreaching in their roles.

In the midst of these circumstances, the summit could not have been timelier. This *ViewPoints* synthesizes the perspectives and ideas from the summit and is organized into four sections:³

- **“Regulation is forcing a change in the model of banking”** focuses on the key regulatory trends that are shaping the industry. Summit participants agreed that the regulatory focus on SIFIs presents a number of concerns for those designated as such, and may harm smaller banks as well. Within that

¹ In this document, “director” refers to a member of a bank’s unitary or supervisory board.

² In this document, “regulator” refers to any agency responsible for the development and implementation of rule-based regulatory regimes, and “supervisor” refers to any agency responsible for oversight of management and board actions within those regulatory regimes.

³ This *ViewPoints* also draws on more than 120 discussions with directors, executives, supervisors and banking professionals, and discussions at seven BGLN meetings, over the course of 2011. All discussions were held under a modified version of the Chatham House Rule that encourages sharing of perspectives but absolutely forbids attribution to individuals or institutions. In the context of the summit, the term “participant” denotes directors and guests. All comments from the summit are italicized. A complete list of summit participants can be found in Appendix 1, on page 37. A complete list of interviewees can be found in Appendix 2, on page 39.

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context, key questions remain about the evolving shape of SIFI supervision, although it is clear that supervisors should engage more with senior executives and non-executive directors. Bank leaders concluded that they need to engage in a broader, fact-based discussion with policymakers about the impact of regulatory changes on credit creation and the broader economy.

- **“Serving customers and clients profitably”** picks up last year’s dialogue on improving customer service as a means to improve the industry’s reputation and create pathways to more loyal, profitable customer and client relationships. Participants acknowledged that strengthened consumer protection brings to fore the thorny question of fairness, both in the United States and Europe, and they worried that this mindset was seeping beyond retail customers to high-net-worth and institutional clients. Banks are making major changes to the business models of their core services, and the growing cost of delivery requires major investments in information technology. Directors also worried that the withdrawal of services and new pricing strategies greatly disadvantaged low-income consumers.
- **“Risk governance: the journey continues”** outlines where progress has been made over the past few years in improving risk governance and where challenges remain. Directors agreed that risk appetite processes have improved strategic discussions, but implementing them across the organization presents real hurdles. Banks are focusing on their ability to react quickly to stress scenarios so they can be more agile as the inevitable crises continue to hit the industry. Banks have improved risk reporting considerably, but many participants acknowledged an urgent need to address underlying information technology issues. Overall, participants believe that banks are better able to aggregate risks, but they expressed concern over the industry’s ability to identify and react to emerging risks. Participants also addressed how regulatory and supervisory demands can impact banks’ efforts to improve risk governance.
- **“Implications for banks: focus on growth and profitability levers”** highlights directors’ thinking on how the broader regulatory, political, and economic trends are affecting banks’ economics. Directors tried to see past the clouds to better economic news in Europe and the United States; they agreed the industry should expect lower returns and a continued movement of operations to the United States and Asia. Directors said large banks are considering bold changes to counter the weight of new capital, liquidity, and other such requirements. Banks will have to reduce costs radically, deploy capital more dynamically and efficiently, capture growth opportunities in emerging markets, and consider material changes to compensation levels. They must also redesign service delivery and business models while rethinking the fundamental rationale for some existing businesses.

We hope this summary of candid discussions among some of the banking industry’s most influential non-executive directors will stimulate your own thinking and actions as the industry continues to evolve.



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Regulation is forcing a change in the model of banking

There is a change in the model of society and banks. We thought we could rely on markets for rational answers. ‘Light touch’ wasn’t because people were lazy or incompetent; it was because they thought they could rely on the market. Much of that has been ended. The next decade will be more intrusive. We should think of how we try and reshape a new model. – Summit participant

Since 2009, policymakers, regulators, and supervisors have worked toward improving the safety and soundness of the global financial system through a range of regulatory changes primarily targeting large banks. This changing regulatory environment has been the subject of a number of Bank Governance Leadership Network (BGLN) discussions as bank boards, executives, and regulators consider the implications of rule changes and how best to implement new approaches to supervision. Uncertainty remains as to how this will ultimately play out: in a discussion prior to this year’s summit, a director said, “We are less sure than ever about what issues are most important to regulators. There is much more uncertainty, even compared to last year.”

Regulation will shape industry trends for the foreseeable future; that much is clear. But key questions remain as to how regulation will evolve, and bank boards are therefore considering how to react and what the ultimate impact on banks will be.

On September 26, global bank directors were joined at the summit in New York by Sarah Dahlgren, who heads the financial institutions supervision group at the Federal Reserve Bank of New York; Andrew Bailey, deputy head of the UK FSA’s Prudential Business Unit; and Ted Price, deputy superintendent of the Canadian Office of the Superintendent of Financial Institutions.

Summit participants discussed the status of a number of regulatory changes under way and reached some conclusions about the likely implications:

- Regulatory focus on systemically important financial institutions (SIFIs) raises a number of concerns
- Key questions remain about the evolving shape of SIFI supervision
- Supervision should involve greater engagement with senior executives and non-executive directors
- Bank leaders need to engage policymakers in a broader debate about the impact of regulatory changes

Regulatory focus on SIFIs raises a number of concerns

Immediately after the financial crisis, the issue of “too-big-to-fail” institutions came to the fore of the regulatory debate. National and international regulators are identifying SIFIs, the largest and most interconnected firms, for greater scrutiny and additional regulation, and regulators are being given new tools to manage the buildup of credit in the system, including countercyclical capital buffers. Some think “too big to fail” simply means “too big” and want to shrink banks either directly through regulation or indirectly via rules that make some businesses less appealing or limit the benefits of scale. Others want SIFIs to pay an insurance premium for the risks they represent to society or to limit the potential capital advantage SIFIs may

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have over smaller banks. But it is not clear what impact greater regulation of SIFIs will have on credit or the provision of services needed by global corporations. Directors at the summit discussed a number of concerns regarding the current regulatory focus on SIFIs and its potential outcomes and impact.

Policymakers and regulators lack a clear vision of the ideal banking model

Summit participants concluded that policymakers and regulators do not have a clear vision of the large-bank model they would like to emerge through regulatory reform. A director observed, *“There is a public-policy question: what do the policymakers want the system to look like once they’re finished with it? If you look at Hong Kong, Singapore, China, banks are strong, they have strong capital, but the system is engineered in a way that encourages them to grow risk and take risk.”* The only conclusion one director could reach is that policymakers want *“smaller, less complex”* banks. Another stated directly, *“There is no model among regulators as to what they want. They will sort of let the rules dictate the model rather than vice versa.”*

Additional regulation of SIFIs may have unintended consequences

What is clear is that policymakers and regulators remain focused on identifying SIFIs for greater regulation. While one director asserted, *“We should work out a situation where there is no need for government bailouts, and SIFIs should be taxed at a higher rate,”* several directors questioned the impact of placing additional regulatory burdens on SIFIs. One said, *“The SIFI issue is so obviously prompted by politicians’ fear that they will be caught out again. [Further regulation of SIFIs] will push up costs, make things more difficult. We will look at marginal lending, push prices up, it will impact the economy, and will all be part of the spiral we will live with for the next five years.”* Another agreed that additional regulation of SIFIs may be misdirected, saying, *“If we look at the subprime issue, did it matter if there was a large concentration in a few institutions? The problem was still there. Somebody has to bail out the institutions, and it could be hundreds or even thousands of them. It would be easier to bail out eight or 10 that help support the rest.”*

- **The impact will extend beyond those banks identified as global SIFIs.** Even as the Basel Committee identifies global SIFIs – they have now identified 28 global banks as SIFIs – summit participants noted that other institutions are likely to be impacted beyond the largest global banks. Domestic regulators will still need to determine which banks are SIFIs on a national basis, and in highly concentrated markets it may prompt domestic regulators to apply the same standards to all large institutions. Some regulators have also suggested that domestic banks just below the threshold will be pressured to meet higher capital standards, and the relative cost will be higher for smaller institutions.

In addition, customers and investors may consolidate with those banks labeled as SIFIs. As one director stated bluntly, *“You are too big to fail”* and therefore enjoy a government guarantee, which provides some security for investors and depositors. In a discussion prior to the summit, a bank executive predicted, *“When there is a crisis, when the chips are down and you are worried about getting funding from somebody, there will be a flight to SIFIs.”* A summit participant further forecasted, *“The negative impact will primarily be on smaller banks, not larger banks. We can afford it. Corporates will consolidate with bigger banks.”*

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- **Regulation of global SIFIs is still ultimately about protecting national interests.** Despite efforts to identify SIFIs globally, one director noted, *“SIFIs are really a local issue ... We are going to turn to JPMorgan or Bank of America to save American banks, not Canadian banks or European banks. As each market puts up its own force shield, there is no more global banking.”* Macroprudential supervision is about national interests, not global stability of the system. Additional capital requirements for global SIFIs, though based on global assets, will reside in the home country.

Fulfilling additional SIFI capital requirements may prove challenging

One day after the summit, the Basel Committee announced that it had finalized its methodology for identifying global systemically important banks and would retain the additional loss absorbency requirement – ranging from 1% to 3.5% common equity tier one – as originally proposed in July 2011.⁴ These capital buffers, the “SIFI surcharge,” would be in addition to the Basel III capital guidelines. Attracting more capital in the face of ongoing uncertainty about how sovereign debt issues will be resolved in the midst of the current prolonged period of market volatility may prove challenging.

Although compliance with Basel III will not be required for some time, shareholders and regulators have already pushed banks to increase capital and improve liquidity. A director observed, *“When the regulatory reform agenda started, banks were not trading so much below their book value, so the capital discussion was in a different context.”* Another director noted that sovereign debt issues and their potential impact on bank balance sheets present additional challenges: *“In continental Europe there will be a lot of pressure for another round of deleveraging, a reduction in risk-weighted assets, and pressure on risk weights.”* Requiring a capital buffer for SIFIs is intended to make large institutions safer, but several directors questioned whether it was appropriate to push banks to increase capital, given improvements already made and challenging market conditions: *“Capital and liquidity are very strong. This is not '08. The question is, are they too strong?”*

Regulators are unlikely to soften capital and liquidity requirements, even temporarily

Thus far, regulators and policymakers seem unlikely to heed bankers’ protests about higher capital requirements for SIFIs. Mark Carney, governor of the Bank of Canada and newly appointed chairman of the Financial Stability Board (FSB), said in September, “Authorities are increasingly hearing concerns about the pitch of the playing field for Basel III implementation. Everyone is claiming to be a boy scout while accusing others of juvenile delinquency ... It is hard to see how backsliding [on implementing new capital rules] would help [the global economy] ... If some institutions feel pressure today, it is because they have done too little for too long, rather than because they are being asked to do too much, too soon.”⁵

⁴ Bank for International Settlements, [Outcome of the September 2011 Basel Committee Meeting](#), news release, September 28, 2011.

⁵ Tom Braithwaite, [“Dimon in Attack on Canada’s Bank Chief.”](#) *Financial Times*, September 26, 2011.

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A summit participant noted that it would be problematic for regulators to backtrack, even temporarily, on increasing requirements: *“Some people have asked, ‘Given the weakness of credit growth in the economy, why not relax the requirements?’ I don’t think the framework we have is sufficiently credible that if we said we would temporarily soften it, that it would be understood by the markets.”* The participant added, *“We determined we would need a credible backstop facility provision from the central bank if we would ever relax liquidity requirements due to credit contraction.”* Because of public antipathy to bank “bailouts,” accessing such a liquidity facility now brings with it such stigma that it may not be viable.

Recovery and resolution planning may lead to structural changes

A component of regulating SIFIs is developing mechanisms for the orderly resolution or recovery of these institutions if they get into crisis. A participant stated, *“We must address resolution, otherwise we are pinning the badge of too-big-to-fail on [SIFIs], and we must live with the consequences.”* In July 2011, the FSB released a consultative document titled *Effective Resolution of Systemically Important Financial Institutions*, in which it stated, *“While some jurisdictions have enacted or are considering legislative changes ... the report underlines the need to accelerate reforms of domestic resolution regimes and tools and of frameworks for cross-border enforcement of resolution actions.”*⁶ Even as recovery and resolution plans are developed, questions remain about how these processes would work in practice, across borders and legal jurisdictions.

Some directors questioned whether targeting SIFIs for additional regulation is as much about discouraging banks from becoming too large, or even encouraging them to break themselves up, as it is about making them safer. Said one, *“The endgame is to carve out the retail bank and let ugly investment banks go down to protect taxpayers. But systemic relevance is somewhat inherent in banking. You could have hundreds of institutions, and they could all be impacted.”* Federal Reserve chairman Ben Bernanke said in early October, *“The right response is to put extra cost, extra supervision on these [financial] firms that will give them an incentive to eliminate unnecessary size, to eliminate unnecessary activities, and to reduce their risk-taking.”*⁷

Regulators have focused on ensuring local entities are safe and determining how to avoid the need to bail out SIFIs via two main approaches:

- **Local-entity capitalization and governance.** A director observed, *“Citi is one of the largest banks in Hungary. The group board probably doesn’t think about Hungary much. But if I were the Hungarian regulator, I would worry about that.”* Regulators are increasingly focused on ensuring local entities are well capitalized and governed, and on finding ways to protect local operations in the event that the group runs into trouble.
- **Ring-fencing retail operations.** In the UK, the Independent Commission on Banking, led by Sir John Vickers, recommended requiring banks to “ring-fence” their retail operations to insulate them

⁶ Financial Stability Board, *Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines* (Basel: Financial Stability Board, 2011), 7.

⁷ David Wessel, *“Big Banks Find No Comfort in Capital Cushion.”* *Wall Street Journal*, October 6, 2011.

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from the risks of their wholesale and investment banking activities. A participant commented, *“Ring-fencing is essentially introducing Glass-Steagall. The root is in resolution.”* This participant said there are two objectives: one, to protect a core set of banking activities provided by an entity in crisis because the impact of losing them would be too great; and two, to allow the failure of those elements deemed unessential, but at a much lower cost than was the case in the failure of Lehman Brothers. There are still questions as to what should be included within the ring fence – for example, whether to include large corporate lending and cash management.

Despite objections to spending time and resources developing plans that essentially describe how an institution would fail, several summit participants expressed support for recovery and resolution planning. One said, *“Resolution does allow for, ‘Let’s have a look at this bank and see how it really works, what does and what doesn’t [work].’ We can’t wait until [failure occurs] to have the conversation.”* According to another summit participant, *“We have built out the colleges [of supervisors] and are getting more effective, but there is room for improvement. There is still a reluctance to share information, especially regarding recovery and resolution ... Basel, the IMF lack the authority to intervene. There’s convening, but no intervention.”*

Regulating shadow banking is not a near-term priority

A director put the following question directly to the regulators: *“Should other players active in credit formation be part of your regulatory mandate? We are all concerned about shadow banking. Does raising the cost for banks push things into shadow banking?”* Another emphasized, *“You are not regulating the system if you only regulate banks.”* A participant explained why those firms that could be broadly defined as part of the shadow banking system are not a priority for systemic risk oversight: *“We need to define it: core banking functions outside of banks. I don’t regard hedge funds as shadow banks. They can largely come and go without affecting the landscape.”* Another participant noted, *“The irony is [that] banks supply the credit to support those hedge funds.”*

Directors remain unconvinced that entities beyond banks don’t warrant further regulation and supervision if regulators hope to truly address systemic risk. One said, *“They just don’t want to deal with it or recognize the huge potential impact that is there,”* while another added, *“They look only at specific lists of institutions within their mandate.”* Regulators have had to narrow their priorities, given limited resources and ambitious reform agendas. Some participants believe a failure in a major non-banking institution with systemic impact would be needed to prompt broader regulation of the financial system. A director predicted, *“This will become an issue in the next few years. Pensions and long-term savings will be looking for yield again and they won’t get it from banking. They will go to private equity, hedge funds.”* Many of the new macroprudential regulators will have the authority to expand regulation to unregulated entities.

Key questions remain about the evolving shape of SIFI supervision

Supervisors have made explicit their intention to increase the intensity and depth of supervision and are in the process of shaping their approaches. In November 2010, a group of senior supervisors under the auspices of the FSB, released a report outlining recommendations for enhanced supervision of SIFIs, stating, “Policy

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changes alone are not enough ... Stronger supervision of SIFIs, in good times as well as bad, is necessary to support policy changes. Because of the high cost of the past performance failures in supervisory assessments, supervision of SIFIs must clearly be more intense, more effective, and more reliable.”⁸ But three years after the financial crisis, the details of a new approach have yet to be worked out in practice, and a number of challenges remain:

- **The effectiveness of macroprudential policy is untested.** Policymakers and regulators are focused on improving macroprudential oversight, giving central banks, which have a broad mandate to contribute to financial stability, a more prominent role in micro- and macroprudential supervision, and setting up new regulatory bodies to better gather and analyze data. These institutions will look for deviations in credit growth from long-term trends and will have some tools to try to correct them. But it is not yet clear how these institutions will be staffed, how they will interact with other supervisory bodies or financial institutions, and how they will be able to identify trends and potential systemic risks better than the banks themselves. A director observed, *“Macroprudential supervision: we are all in favor, but nobody quite knows what it means ... The interaction between microprudential and macroprudential regulation has not been thought through at all. It will take thoughtful, clever people, which there aren’t enough of, to think through it for a long time, if they have time. But they are busy putting out fires.”*
- **A level playing field across jurisdictions remains highly unlikely.** Directors observed that differences across markets have become more marked, rather than less, in recent months as national regulators focus on protecting local taxpayers and institutions. One director asserted, *“The lack of coordination across regulators is a problem. We will have fragmented, different regulations across borders.”* Not only does this create challenges, but it also, as one director said, is destroying the model of global banking: *“There is no more global banking if local market regulators are setting their own standards.”* Another agreed: *“Macroprudential policy means the idea of a level playing field’s time has passed. We better realize that.”*
- **Degrees of supervisory intervention vary.** Supervisors, while agreeing in principle about the need to improve engagement, are taking different approaches. Most are working to be more proactive and more deeply engaged, but the level of intrusion into decisions historically left to management and the board varies. Broadly, there are two approaches to supervision: (1) earlier, proactive intervention; and (2) deeper understanding of firm risks and strategy. Some supervisors have made clear their intention to intervene in decisions – for example, to stop acquisitions or stop banks from launching new products – while other supervisors are taking a less direct approach, aiming to develop deeper insight into firm risks and strategy and expressing any concerns, rather than intervening directly in decisions. Even those who step into decisions and make earlier judgments are still debating how far to go. A participant said, *“The concern is you need to be focused or there can be no end to the things you can be intensive and intrusive about.”*

⁸ Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* (Washington, DC: Financial Stability Board, 2010), 1–2.

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- **The level of supervisory involvement in innovation is unclear.** *“Innovation used to be viewed as good. Now we hear, ‘The only good innovation is the ATM.’ Do you take a view on, for example, [collateralized debt obligation] squared or the speed of transactions in securities markets as distinct from supervising individual institutions?”* a director asked. One participant said, *“Where there are market practices, we have a role in understanding the market, making sure participants understand, and making sure those markets are not disruptive. There are some good questions about banking products and who benefits. Does it help facilitate commerce? Help the economy grow?”* Another participant said, *“We do need to understand the risks of innovation. We do not have superhuman wisdom, but we need to think about these things carefully. There was an unrealistic credibility given to market discipline. Everybody gets it wrong, and they get it wrong for a long period of time.”*
- **Supervisors face a significant talent challenge in meeting expanded objectives.** For supervisors to fulfill their ambitions, they need enough senior people to engage at senior levels and make difficult judgments. Directors were encouraged by the way senior regulators have described their objectives, but several directors agreed with one who observed, *“There is still some disconnect between the way they speak and what we see on the ground.”* Another added, *“Tone at the top is OK, but it will take time to communicate it and for everyone to dance the same dance.”*

Supervisors are working to move more senior people into key positions, but do not seem to have identified a clear way to address this challenge. A director asked, *“How many [institutions] can you have the quality dialogue with? What is the capacity? How many can be managed at one time?”* A participant said, *“We are training our people, getting the right people into the roles,”* and another said the objective was to increase the seniority, not the number of staff. One of the participants commented, *“At the most senior levels, we can hire the talent to do it: people with 25 to 30 years in the industry, either with deep technical expertise or experience running a business unit or big branch, where the [supervisor] is the last stop in their career.”*

Supervision should involve greater engagement with senior executives and non-executive directors

In a series of BGLN discussions between March and May 2011, non-executive directors of large banks and senior supervisors met to discuss the evolving nature of supervision and in particular how supervisors can effectively engage non-executives and senior executives.⁹ At the summit, directors and the three supervisory guests continued the dialogue.

A director said, *“I am deeply convinced that we need deeper coordination with regulators. We have the same interests: to avoid problems for our institutions and our industry. Unfortunately, it does not happen. What is missing is the ongoing dialogue.”* Essential to an evolving approach to regulation is a mutual effort to improve dialogue between senior supervisors and C-suite executives and directors. A participant posed the question, *“What can we and you do to motivate a more constructive dialogue? Given pressures, how do*

⁹ For more on the evolving nature of bank supervision, see Bank Governance Leadership Network, [“The Changing Shape of Banking Regulation in Europe.” ViewPoints](#), June 20, 2011.

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we engage to get to a better place regarding the dialogue? ... Now, it seems to happen via the press, and both regulators and banks are vilified.”

Changing the level and nature of engagement

Participants supported the following approaches to improving engagement:

- **Supervisors should target the most important institutions.** A participant said, *“We should be engaging with the top 10 to 15 institutions at a very different level, and I think that is within our capacity. Then it would be one-offs, depending on issues, risks we see.”*
- **Supervisors need free access to the board.** A director advised, *“You should speak with non-executive directors independently from management. If there is pushback from management, that is a flag.”* Another said supervisors should watch for inconsistent messages between management and the board.
- **Candid exchange of concerns and perspectives is required.** Several participants agreed with one director who said, *“You should have an open pathway to the risk committee chair [and] audit committee chair and say, ‘these are our real concerns,’ and vice versa. We need to be totally open and express concerns in an open way. It can be difficult; it’s not always fun to hear. [But] we have made a huge amount of progress.”* Another added, *“It has to go both ways. Directors need to understand regulators’ concerns, too.”* Both directors and supervisors acknowledged, *“It also takes time to build trust. It is based on the willingness of the CEO and chairman, because that will influence the candor and dialogue with [non-executive directors].”*
- **Supervisors should develop a more complete picture of the organization.** A participant said, *“It is important to triangulate what we see in the company, what we hear and see from management, and what we hear from you all – does it all make sense?”*
- **Supervisors can offer valuable benchmarking across institutions.** A director noted, *“Benchmarking is very important. We need more dialogue about where we are relative to others. We expect that from the external auditor too.”*
- **Supervisors need to discuss the right issues at the right levels.** Supervisors should discuss key strategic and risk issues with senior executives and directors, and not get bogged down in minor technical details. Similarly, more junior personnel need to appropriately raise any issues between the supervisors and bank employees that arise at lower levels of the institution, especially when there are disagreements. A summit participant said, *“There are always multiple sides to any issue, so they need to be escalated and discussed. But we also want our people to be empowered and feel supported.”*

Setting appropriate expectations for the board

A consistent theme in these discussions is concern from directors that supervisors are setting unrealistic expectations of the board. That in turn is driving more and more approvals and compliance items onto board and committee agendas, where the board can add little value. As more supervisors get more deeply

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engaged with directors and assess governance effectiveness, it is increasingly important that both sides have a shared set of expectations. One director said, *“It is not clear what they want to hold the board and management accountable for.”* Another said this raises important questions: *“[Our supervisor] did a governance review – they seem to be pushing the board into more and more things. What will this mean for board members? [What is] the time commitment? Will we be able to recruit the kind of directors we need?”*

A participant observed, *“I don’t think there is clear agreement among regulators and boards regarding the role of the board. After all this, why do we still have the same debates?”* More direct engagement would be helpful in developing a common understanding, but directors said regulators might need to adjust their governance guidance and be clearer about the role of non-executives. One observed, *“They are hazy on the role of non-executives. They have to pin down [non-executive director] responsibilities more tightly.”*

Supervisors are considering not only how to engage more with directors, but also how best to assess governance effectiveness. Summit participants discussed two approaches:

- **Sitting in on board meetings.** In order to understand how effective boards are, some supervisors are considering sitting in on board meetings; in some countries, it is a regular practice already. A director exclaimed, *“They want to come and observe independent challenge in the boardroom! It is absurd.”* Most directors agreed that real discussion will simply take place elsewhere. A participant acknowledged the potential pitfalls and questions that arise regarding accountability for decisions institutions make when supervisors are present: *“I would not want to attend every board meeting because I want the responsibility on you as directors.”*
- **Vetting new directors and senior executives.** While most supervisors have a test of suitability for new directors, some have gone further, interviewing and approving any new appointments. One participant stated, *“I don’t think we are in a better position than boards.”* All participants agreed that supervisors should *“at least be interested in meeting new directors, engaging them.”*

Bank leaders need to engage policymakers in a broader debate about the impact of regulatory changes

Regulators are primarily focused on safety without balancing the need for credit growth. A director asserted, *“You need to allow the system to make a return on equity. Policymakers don’t care that banks are trading at half book, but as a result, there is no capital that wants to come in.”* There is a sense among directors that regulators are *“overly focused on avoiding a problem versus getting the industry to play a role it needs to play.”* A director asked, *“Are you afraid you’ll be criticized if something goes wrong, but not if there is a lack of growth because it is not in your mandate?”*

A participant acknowledged, *“There is a tension between strengthening prudential standards: capital and liquidity, ironing out egregious issues, and balancing the impact on credit ... [Regulators] can’t shirk any responsibility for credit growth. We should at least have an intelligent debate about how to make it better. It is a sensible debate at this stage ... We need to get out of the blame game. We don’t want a no-fail regime, but that is easier said than done. [Politicians] are a long way away from understanding that point.”*

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Another summit participant made a different point: *“A safe banking system is fundamental to credit creation. Demand will drop faster than supply if people don’t trust the banks’ safety.”*

Directors concluded that if they are to influence the debate about the extent to which regulation threatens economic growth, they have to engage at two levels: directly with policymakers, and at the grassroots, rebuilding trust with consumers. Another director said, *“We need to cooperate more to engage with policymakers. It is not as valuable influencing regulators now. We need a better, more collective way of engaging.”* But participants also emphasized that they need to provide objective analysis about the impact of regulation, not just lobby in purely self-interested ways, engaging senior industry leaders in direct discussion with policymakers.

Despite all the work devoted to regulatory reform, some directors remain skeptical that regulators and policymakers have got it right. A director asked, *“Would all this re-regulation have stopped the excesses of ’03 to ’07? Even the regulators say no, so why have we embarked on this whole process?”*

If the industry is to be successful in engaging policymakers in a dialogue to identify an approach that balances the need for safety and the broader need for a robust financial system that is free to take risk, they may need to better articulate what alternative approaches to regulatory reform would be more effective and why, rather than simply protest what some regard as “moderate” changes. Regardless, banks need to accept the realities of a new regulatory paradigm that could require structural and business-model changes.

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Serving customers and clients profitably

The business model will need to change in drastic ways, and the sooner, the better. Once everybody knows the rules, business models will change ... banks ultimately will have a better profit model.

– Summit participant

Since first convening in 2009, participants in the BGLN have discussed the critical, though sometimes strained, relationships between banks and their customers. At the 2010 Bank Directors Summit, directors agreed that improving customer service would both help repair the industry's reputation and create pathways to more loyal, profitable client relationships.

This year, summit participants engaged Elizabeth Duke, a member of the Board of Governors of the Federal Reserve System, in a dialogue about the key issues related to serving customers and clients profitably. (Until recently, Ms. Duke oversaw the Federal Reserve's consumer protection policies.)

Summit discussion focused on five key issues:

- Strengthened consumer protection brings to fore the thorny question of fairness
- The consumer protection mindset is seeping into the regulation of high-net-worth and institutional client offerings
- Major changes to core business models are being considered
- The growing cost of delivery requires major investments in information technology (IT)
- The withdrawal of services and new pricing strategies greatly disadvantage low-income consumers

Strengthened consumer protection brings to fore the thorny question of fairness

Political reaction to the financial crisis has extended well beyond concerns that banks were unaware of the risks. There is also deeply held perception among policymakers that banks were putting themselves first, ahead of the customer, and that belief has motivated a host of regulatory actions since the crisis began. The Senate summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 put the perspective starkly:

The failures that led to this crisis require bold action. We must restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them.¹⁰

As a consequence, strengthened consumer protection has been a key thrust of the recent legislative and regulatory activity, which has had the following effects:

- The establishment of new agencies with tougher powers and broader mandates

¹⁰ US Senate Committee on Banking, Housing, and Urban Affairs, "[Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)," 1.

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- Even less clarity about what it means to treat one's customers fairly
- Greater need for banks to adopt to a truly customer-centric culture

The establishment of new agencies with tougher powers and broader mandates

New supervisory agencies have been established in the United States and Europe with broad mandates to protect consumers. In the United States, Dodd-Frank created the Consumer Financial Protection Bureau (CFPB), which consolidates most federal consumer financial-protection authority in one place. The bureau, which is an independent unit within the Federal Reserve, is focused on one goal: “watching out for American consumers in the market for consumer financial products and services.”¹¹ It aims to “promote fairness and transparency” by setting rules that “let consumers see clearly the costs and features of financial products and services.”¹² The bureau has already staked out a relatively expansive territory of entities to oversee, including ones that would have fallen outside the Federal Reserve’s scope in the past because of their size or non-bank status.¹³

The European Parliament has established the European Banking Authority, which officially came into being on January 1, 2011. The agency has taken over the tasks and responsibilities of the Committee of European Banking Supervisors¹⁴ and will, among other duties, draw up European standards for consumer protection and financial innovation.¹⁵ In the United Kingdom, the Consumer Protection and Markets Authority, slated to replace the FSA, “will be responsible for regulating the way financial firms treat their customers, and for overseeing the way the financial markets, including the stock market, operate.”¹⁶

It is too early to predict how these agencies will affect consumer protection. Early signs suggest the impact could be significant, for example in the area of product development. In several jurisdictions, regulators have indicated their intent to get more heavily involved in product development. The FSA announced in a January 2011 discussion paper that it intended to become involved in product development. It stated that it had radically changed its regulatory approach and would henceforth “intervene earlier in the product value chain, proactively, to anticipate consumer detriment.”¹⁷ At the summit, several directors noted these new agencies might have already had an effect beyond their domestic borders, as other regulators feel the pressure to become more interventionist. One participant said, “[Our supervisor] is all over us, all over new products. In one case, they stopped the bank because they didn’t think we had the systems and processes in place.”

¹¹ Consumer Financial Protection Bureau, “[Creating the Consumer Bureau](#),” accessed October 27, 2011.

¹² Federal Register, “[Consumer Financial Protection Bureau](#),” accessed October 27, 2011.

¹³ See Bureau of Consumer Financial Protection, “[Defining Larger Participants in Certain Consumer Financial Products and Services Markets](#),” notice and request for comment, 2011.

¹⁴ European Banking Authority, “[About Us](#),” accessed October 27, 2011.

¹⁵ European Union, “[European Banking Authority \(EBA\)](#),” last modified March 10, 2011.

¹⁶ Jill Treanor, “[Martin Wheatley to Lead New Financial Watchdog CPMA](#),” *Guardian*, February 2, 2011.

¹⁷ Simon Read, “[FSA Says No to Calls for It to Pre-Approve Products](#),” *Independent*, September 28, 2011.

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Even less clarity about what it means to treat one's customers fairly

While the concept of “fairness” has been at the core of consumer protection for years, recent changes in law and practice have elevated concerns in the industry about how best to treat customers fairly.

In the United States, the legal terminology has become less clear. One summit participant said, *“‘Unfair and deceptive’ has a specific legal meaning. Did the customer have the ability to know what might happen and avoid it? ... We have to consider, what information is the customer using to make the decision? Most are looking at how much it costs a month, and the more responsible are thinking, ‘Can I afford to pay that?’”* While banks have long navigated through these difficult questions, the challenge became more complicated with Dodd-Frank’s introduction of the term “abusive practices,” which the CFPB can use in its consumer-protection activities. One summit participant emphasized that the bureau will likely view this as a call to act more preemptively. However, since the term *“has not been legally defined,”* banks are re-thinking the question, *“What is the evidence of whether the customer was treated fairly?”*

In the United Kingdom, fairness has moved from a program focused on guidance to a core part of supervision. The FSA launched its Treating Customers Fairly program more than a decade ago and refreshed it in 2006.¹⁸ In 2009, the FSA took a major step by formalizing the program into its core supervisory process. Sarah Wilson, director of Treating Customers Fairly, described the changes to board directors:

Treating Customers Fairly has now moved into the FSA’s core supervisory work. Put simply, this means that it is now a key aspect of supervisory reviews (Arrow reviews), it remains key to the small firms supervisory strategy, and that you can expect to continue to see it reflected in both our thematic work and our enforcement action. Firms are expected – and by that I mean senior management, including the Board – to be able to demonstrate to themselves and to us that they deliver fair outcomes to their customers.¹⁹

The trend toward tougher consumer protection rules extends beyond the United States and United Kingdom. One participant said, *“It is not as codified in Europe, but the mentality is seeping in ... It is less prominent. It is more of a concern, but in public, it is less of an issue.”* Another European director added, *“We have a new law that puts the customer first. It has changed the paradigm, so we discuss it at every board meeting, the implications on the customer, customer behavior.”*

Summit participants expressed deep concern about these developments. A director said, *“In the UK, we have [the notion of] treating the customer fairly, regardless of what the contract says.”* Another director said, *“There is always interpretation. That is the issue ... ‘Fairly’ is a horrible word because ‘fair’ is in the eye of the beholder, with the benefit of hindsight.”* Another director pointed out the frustrating reality: *“One only finds out 10 years after the product is sold whether [customers] will sue.”* Directors concluded that there is rarely consensus about what constitutes fairness.

¹⁸ Friends Provident Life and Pensions, [“Treating Customers Fairly,”](#) last modified August 4, 2009.

¹⁹ Sarah Wilson, [“Treating Customers Fairly – Issues at Board Level”](#) (speech, ABI Seminar for Non-Executive Directors of Insurance Companies, February 5, 2009).

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In this context, a number of directors expressed concerns about consumer financial education. They noted that millions of customers simply do not understand the details of products well enough to make an informed decision. One participant pointed out, *“No matter how nicely you treat your customers, if they don’t understand the products, it doesn’t matter. It’s not just disclosure, because the consumer may not understand what’s in the disclosure.”* Another observed that even common products can be difficult for the layperson to comprehend: *“Mortgages are actually a complex product; the disclosures are complex.”* One non-executive said bluntly, *“Twenty percent of the people in the UK do not understand percentages. That means one in five would not understand what I just said.”*

Greater need for banks to adopt to a truly customer-centric culture

The focus on fairness emphasizes the need for banks to adopt a more customer-centric culture. Directors are challenging their firms to improve and profit from mutually beneficial, trusting customer relationships. In a conversation prior to the summit, one director asserted that boards and executives “can inject principles, deeply engrained in the organization, that act to regulate the behaviors of people. [The principles] are enduring and survive current management ... For example, ‘customer needs drive our actions’ – so you identify customer needs, which ones you want to satisfy, and drive to provide services and products to satisfy them. Otherwise, you will sell anything [that people] are dumb enough to buy.”

During the summit, directors noted progress in this area, with one saying that the crisis *“has unleashed a lot of marketing talent and initiatives that in the long term will improve our approach to the consumer.”* However, directors acknowledged that in the short term, tactical improvements have been pragmatic in nature. A participant asked the group how banks were improving customer service, saying that customer complaints *“can be a way to find seeds of issues before they become larger.”* Responses were encouraging. One stressed the importance of *“more personal, proactive customer service,”* while another suggested *“improving data collection.”* A third suggested a *“single point of contact for customers across products.”*

The group was clear that improved service doesn’t come without cost. Once again directors emphasized the need for balance. One participant reminded others of the trade-off between access and cost: *“It costs more to deal with people at lower levels. As consumer protection grows, it raises the costs of dealing with that segment.”* As such, another participant asked, *“How do we provide the protection without adding to the cost?”*

The consumer protection mindset is seeping into the regulation of high-net-worth and institutional client offerings

In discussions in advance of the summit, several directors expressed concern that the consumer protection mindset seems to be seeping into other market segments, such as high-net-worth clients and other sophisticated investors who are sufficiently knowledgeable to evaluate the merits of investments by themselves. “The real issue [for suitability] is institutional customers,” said one bank director. “It used to be, once you had made your disclosures, you were done. Yet it seems that even with sophisticated buyers, there is now an elevated set of responsibilities.” A summit participant shared the concern, saying outright, *“There is a trend of creeping into suitability for institutional customers.”*

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There were signs of such a trend in Europe even before the financial crisis, as was evident from the European Union's Markets in Financial Instruments Directive, which sought to strengthen client protection.²⁰ However, the financial crisis has accelerated this trend. In the United States, the new Financial Industry Regulatory Authority (FINRA) Rule 2111 raises the broker's suitability obligation, particularly when it comes to communicating recommendations regarding buying, selling, or holding an equity position.²¹ Several summit participants said other countries are heading in this direction.

While directors believe their banks are accustomed to changing their product approval and sales processes to protect consumers, they are less confident in their banks' ability to manage such changes in other client segments. They know the costs of delivery will rise, as will associated legal risks. But some believe that more board-level oversight may be required. Several directors noted before the summit that they were spending more time understanding the product development and approval processes for institutional clients. Some reported that their audit committees were watching those processes more closely. One said, "The audit committee charged the bank to evaluate how fees were set or product decisions were made, with a view to identifying where there were potentially adversarial customer relationships ... but it's hard to tell which are high risk." A director observed that as a consequence, "we all now have some worries about the suitability of investment products."

At the summit, participants described other ways in which their banks are adapting to this new concern. Said one director, "*Whenever a new product comes out, we discuss the return, the reputation risk, and where [the product] fit[s] in the assets on the balance sheet. It shows ... that we often don't really understand reputation risk across the business of some product innovations.*" Another participant said, "*We have closed businesses down because [we determined that] we didn't fully understand the risks and rewards.*"

Major changes to core business models are being considered

Banks are being forced to consider radical changes to the business models that underpin some of their core banking services. Changes are in various stages of progress, with some having largely already taken place, some just starting, and others still to be determined. The most striking changes are the following:

- Major adaptations to credit card pricing
- The slow demise of "free" checking accounts
- Reform of housing finance

Major adaptations to credit card pricing

Consumers have never liked certain credit card pricing practices, such as unannounced rate increases, unannounced credit reductions, over-limit fees triggered solely by annual fees, and preapproved or other special offers that are not honored.²² Following the crisis, US lawmakers took direct aim at what they

²⁰ European Commission, "[Reports Required by the Markets in Financial Instruments Directive \(MiFID\)](#)," last modified June 14, 2010.

²¹ See Ernst & Young, *Ten Things a Compliance Officer Should Consider* (Ernst & Young Global Limited, 2011).

²² "[Credit Card Abuse, Fees and Rate Hikes](#)," *LawyersandSettlements.com*, last modified March 7, 2011.

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deemed to be deceptive pricing processes for credit cards. The Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009 reduced or eliminated unfair credit card rate hikes and hidden fees to customers; for example, issuers may no longer allow cards to go over their limits automatically, nor can they raise interest rates during the first year after an account is opened. (Once the year is up, the cardholder must receive 45 days' notice before a rate hike.)

According to recent studies, the industry has changed its practices in four significant ways as a result of the CARD Act:

- The practice of raising existing customers' interest rates has declined
- Late fees are down substantially
- Overlimit fees have almost been eliminated across the industry
- Costs are conveyed more clearly on monthly statements²³

Even with these changes, banks continue to evolve their pricing approach and underlying business models. Product development and marketing teams are testing fee-generation and cost-reduction initiatives, such as monthly fees for debit card usage, and the termination or scaling back of debit rewards programs.²⁴

The CFPB recently held a conference to highlight the new law's initial success. A statement from the event took an optimistic view of the market response:

The CARD Act curtailed certain practices in the credit card industry that were neither fair nor transparent to consumers and created unanticipated costs. The result has been to make credit card pricing more transparent, so that upfront interest rates now more accurately reflect the true cost of the credit card. While front-end pricing has increased, the overall cost of credit has not. The effective interest rate paid by consumers did not increase and is no higher today than it was in 2007 or 2008.²⁵

Directors tended to be less effusive and said they believe that pricing will eventually rise. One participant predicted, *"Ultimately, we will see higher minimum payments, which will cause political issues. I think card issuers will still issue to anyone they think they can earn a profit on."*

The slow demise of "free" checking accounts

For years, banks have marketed "free" checking or banking to consumers in which the costs associated with the account were subsidized by other charges. Instead of a fixed monthly fee, banks used a portion of the interest earned on the deposits or overdraft fees to pay for service delivery. This strategy worked well for many years in terms of attracting new deposits.

However, this pricing approach has come under fire in recent years, notably with regard to fees associated with overdrafts. First, the UK Office of Fair Trading won its case to force banks to repay certain overdraft

²³ Consumer Financial Protection Bureau, ["CARD Act Fact Sheet."](#) February 22, 2011.

²⁴ Blake Ellis, ["Wells Fargo: No More Debit Card Rewards."](#) *CNNMoney*, August 22, 2011.

²⁵ Consumer Financial Protection Bureau, ["CARD Act Conference: Key Findings."](#) accessed October 27, 2011.

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fees.²⁶ Then, the Federal Reserve Board of Governors issued new rules requiring banks to seek the consent of customers to charge certain overdraft fees.²⁷ In addition, the low interest rate environment has further eroded the economics behind checking accounts.

This has forced the industry to reconsider free banking. As one summit participant noted, *“Free banking is not free ... It will ultimately be beneficial to address that. If you are running a business with costs associated, you need to recover them.”* In doing so, said another director, *“There will be higher charges for checking, more realistic pricing of services.”*

Banks are moving swiftly to change their models. A survey by Bankrate.com found that the proportion of free checking accounts (of the non-interest-bearing variety) fell to 45% in 2011, down from 65% and 76% in 2010 and 2009, respectively.²⁸ Moreover, according to the 2011 Checking Account Survey, the number of free accounts “is likely to drop further as banks and their customers adjust to recent regulatory changes.”²⁹ Large banks have signaled that they intend to institute alternative debit card fees.³⁰

However, these announcements have been sharply criticized, with dissatisfied customers garnering a growing level of media attention. Politicians have also reacted. President Obama said in a recent interview:

This is exactly why we need [the CFPB] ... somebody whose sole job it is to prevent this kind of stuff from happening ... You can stop it because if you say to the banks, You don’t have some inherent right just to – you know, get a certain amount of profit. If your customers – are being mistreated. That you have to treat them fairly and transparently.³¹

Making the situation worse, banks are instituting these changes at a time when the industry’s reputation remains in tatters. A global retail banking survey conducted by Ernst & Young at the end of 2010 found that among more than 20,500 banking customers interviewed, 44% had lost confidence in the banking industry over the past 12 months.³² In addition, customers are showing a higher tendency to switch banks in the post-crisis era. Ernst & Young found that “globally, attrition levels are significant, with 7% of customers worldwide planning to change their main bank and the number of Europeans who have ever changed their main bank up 15% compared with a year earlier.”³³

Clearly, the industry faces a major reputational challenge in moving toward a more sustainable business model for checking accounts, the long-term benefits notwithstanding.

²⁶ “Banks Lose Overdraft Charges Case,” *BBC News*, April 24, 2008.

²⁷ Board of Governors of the Federal Reserve System, [news release](#), November 12, 2009.

²⁸ Claes Bell, “7 Ways Checking Accounts Cost You More,” *Bankrate.com*, accessed October 27, 2011, 2.

²⁹ *Ibid.*, 1.

³⁰ Kelly Phillips Erb, “Bank of America Debit Card Fees Slammed as ‘Durbin Tax,’” *Forbes*, October 4, 2011.

³¹ “Transcript: George Stephanopoulos’ ABC News/Yahoo! News Exclusive Interview with President Obama,” *ABC News*, October 3, 2011, 4–5.

³² Ernst & Young, *A New Era of Customer Expectation: Global Consumer Banking Survey 2011* (Ernst & Young Global Limited, 2011), 2, 5.

³³ *Ibid.*, 19.

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Free corporate banking is in question

While the summit discussion focused primarily on fees for retail customers, there are signs that the trend toward fee-based deposit accounts may extend to corporate banking relationships as well. For example, Bank of New York Mellon recently announced new fees for large corporate clients. The *Wall Street Journal* reported, “The giant bank, which specializes in handling funds for financial institutions and corporations, will begin assessing a fee next week on customers [with deposits above \$50 million].”³⁴ Some analysts say that other banks might follow suit.³⁵

Reform of housing finance

The mortgage market remains a conundrum for the industry. Changes continue to be made, from new foreclosure practices to less complicated mortgage offerings. Tougher oversight of mortgage brokers is being considered, as are ways to force banks to hold portions of mortgage-backed securitizations on balance sheet. Even sacrosanct issues, such mortgage tax relief, are being discussed in the midst of US Republican presidential primaries. Change is afoot.

But critics complain that radical change is being avoided. Government intervention in the market is ongoing, through new refinancing programs and activities by Fannie Mae and Freddie Mac. Moreover, while many solutions are being discussed, few have been implemented.

One participant commented: *“On mortgages, I just think you almost need to start over: the incentives at origination, tax deductibility of interest. When we understand what the private market will look like, then we can address [government-sponsored entities]. It will take years. We don’t want to short-circuit that with a patchwork response.”* However, few summit participants expect a comprehensive solution. The long-term effect on mortgages is thus hard to predict.

The growing cost of delivery requires major investments in IT

Banks recognize that the confluence of lower revenues, lower markets, higher costs of delivery, and ever more burdensome requirements to monitor consumer behavior mean that a step change in IT investments may be required. See “Increasing costs of monitoring customers” on page 21.

However, no one understates the challenge that the industry faces in upgrading its IT systems. One bank chairman said before the summit: “Banks [have] increased IT processes, upgrades, adding parts – both hardware and software. [But] they ended up with thousands of programs, silos, a huge amount of spaghetti. It creates problems, a mess ... Replacing your platform takes five years at least and requires a multibillion-dollar investment.” A director at the summit agreed, saying, *“Serving [customers] will get very expensive because of technology [investments required].”* Directors also fear IT security threats. As one participant noted, *“Security [associated with mobile banking] is a huge issue ... That was the case with online banking, with ATMs. The challenge is, security is not the software developers’ primary concern.”*

³⁴ Liz Rappaport, “New Fee to Bank Cash,” *Wall Street Journal*, August 5, 2011.

³⁵ *Ibid.*

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Increasing costs of monitoring customers

- Banks have been required to monitor the behavior of their banking customers and clients to increasing degrees over the past 20 years. In the United States, requirements date to the Bank Secrecy Act of 1970, followed in 1986 by the Money Laundering Control Act.³⁶ The 1990s saw a raft of new laws, including the Annunzio-Wylie Anti-Money Laundering Act (1992), the Money Laundering Suppression Act (1994), and the Financial Crimes Strategy Act (1998).³⁷ The Patriot Act of 2001 and the Intelligence Reform and Terrorism Prevention Act of 2004 reframed anti-money laundering efforts as part of the greater war on terrorism.³⁸
- Know-your-customer initiatives have also taken hold globally, requiring banks to identify and report transactions of a suspicious nature to the financial intelligence units in their respective countries. Banks must perform due diligence that includes not only knowing the identity of the customer but also understanding his or her business and transactions. Banks are expected to recognize unusual or suspicious behavior that might indicate money laundering.
- Since the crisis, tax and law enforcement officials have also increased their focus on customer behavior that appears to be motivated by a desire to avoid taxes. The US government has responded by stepping up its focus on tax evasion. More broadly, it has increased pressure on foreign banks to monitor the behavior of their customers and clients by passing the 2010 Foreign Account Tax Compliance Act, which, when it comes into effect in January 2013, will require institutions to withhold 30% of interest and dividend payments from US citizens who provide inadequate information.³⁹

However, directors recognize that they need to adopt a different mindset regarding IT investments. First, these investments can directly contribute to growth and better client service. As one director said before the summit, “[Every bank] needs to think about the [IT] platform for growth. You need the tools.” That director went on to highlight the opportunities new IT creates:

We need to bring the convenience of the 21st century to the customers: a simple connection ... with superb service via smart phones connected to computers, etc. There will be far less human beings and far more virtual tools. We will use avatars – we can manufacture people.

Second, boards may need to consider a new approach to oversight of IT issues, especially when these investments are set alongside ongoing, multiyear investments in new finance and risk IT systems. In a pre-summit conversation, one participant said, “The IT spend issue has to be thought of differently ... There’s the ongoing investment in IT infrastructure [that’s needed to run our business] – this is a sunk cost, where talk of a return on investment is meaningless ... Then there’s the IT investment we should be making to

³⁶ Financial Crimes Enforcement Network, “[History of Anti-Money Laundering Laws](#),” accessed October 27, 2011.

³⁷ [Ibid.](#)

³⁸ [Ibid.](#)

³⁹ See Ernst & Young, “[The Facts on FATCA](#).”

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understand our customers and develop products that meet their needs ... The problem is, management often tries to have a return on investment in all IT [investments].” The governance question then becomes one of who at the board level is evaluating management investment in these core components of IT spending.

The withdrawal of services and new pricing strategies greatly disadvantage low-income consumers

Looking beyond their own bank’s economic situation, directors are concerned that enhanced consumer protection obligations and new business models for credit cards and checking accounts may most adversely affect the consumers that politicians most want to protect – those with low incomes.

Directors pointed out that banks have already pared back services to this group. As one European participant noted, *“We have reduced the number of products we offer in mortgages and savings”* as a result of new consumer protection laws. Another director noted that before the CARD Act was passed *“there were \$5.5 trillion of lines at the start ... When the act was passed, it went to \$3.7 trillion. The rest was taken from people who needed the credit.”* Directors also noted that new pricing strategies will have an effect. One director said, *“Free checking will change. [Charging] will chase out a lot of customers from traditional checking accounts.”*

The question on directors’ minds is whether lawmakers have fully considered the unintended consequences of their actions on consumers most in need. Earlier in the year, at another BGLN meeting, a director warned, *“There comes a point where the capital won’t be available, or it becomes so expensive that it drives people higher on the risk spectrum into unregulated entities.”* At the summit, another director suggested that the new environment *“will push the lower echelon out of [traditional] banking. No one will support that market. It will push them into other institutions, and it will become a huge political issue.”*

Serving consumers and clients profitably has never been so challenging. New laws are forcing banks to change the way they interact with their customers and price their products and services. However, consumer and political discontent is making such changes difficult to execute. Now, more than ever, bank boards should engage their executive teams in active dialogue on their overall customer and client strategies. After all, these issues will have a huge impact on the bank’s reputation, economics, and underlying compact with society to continuously offer critical banking products and services.

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Risk governance: the journey continues

[Risk appetite] has become pervasive in the board dialogue. – Summit participant

Improving risk management and oversight in financial institutions has been a priority for regulators and banks since the financial crisis. Driven by a combination of regulatory pressure and self-evaluation, banks began a process of improving risk governance. Initially, many focused on how to increase board engagement in risk and improve the link to strategy. In addition, most banks that had not previously done so established separate risk committees to ensure due attention was given to focused risk discussion. Much of this discussion centered on newly written risk appetite statements, how those statements linked to the broader risk framework and limit structures, and how they could facilitate discussions regarding new business and the allocation of capital.

During a session at the third Bank Directors Summit on September 27 in New York, Hank Prybylski, global financial services risk management leader for Ernst & Young, joined participants to discuss where banks have made progress in risk management and governance, what challenges remain, and how that is affected by regulatory demands for improvement.

Summit participants agreed that the renewed focus on a more formalized risk discussion has yielded significant benefits and pointed to tangible improvements in the way management and the board think and communicate about risk. But regulators continue to push for improvements, and while progress has been made, success remains a moving target.

Discussion focused on the following:

- Risk appetite statements have enhanced strategic discussions, but implementation challenges remain
- Banks are focusing more on their ability to react quickly to stress scenarios
- Banks have improved risk reporting but must address underlying IT issues
- Risk committees struggle to remain forward-looking
- Banks are seeking better ways to identify and respond to emerging risks

Risk appetite statements have enhanced strategic discussions, but implementation challenges remain

Banks continue to adapt risk appetite statements, refine the mandate and agenda for board and management risk committees, and build out risk management capabilities, including risk teams and information systems. All of this requires significant investment, and though most bank directors cite marked improvement, questions remain as to how best to focus resources. In the meantime, the economic and market environment continues to challenge risk organizations to identify emerging risks and challenge management and the board to respond accordingly.

Directors are particularly pleased with the progress their institutions have made in articulating risk appetite and tying that to strategic discussions. Several directors said that risk appetite was prevalent in all board

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discussions. Still, regulators continue to push for improvements in implementing risk appetite statements. In November 2010 the FSB published a report on intensive and effective supervision, in which it stated that “supervisors ... should be asked to consider more stringent SIFI assessment criteria when it comes to the setting and monitoring of risk appetite, aggregating data to feed the risk control and oversight functions, and in finding ways to make the complex firms more able to be overseen by boards and supervised by authorities.”⁴⁰

Mr. Prybylski noted that regulators are seeking greater consistency among firms’ risk appetite statements. A director also observed, *“Regulators are OK with risk appetite as to the risks we want to take. They are not comfortable with risks such as technology risk, reputational risk, and so on. There is pressure on the risk committee to focus on these.”* Part of the challenge, according to one director, is that regulators and institutions may focus on different priorities when it comes to improving risk appetite statements: *“The people within the regulators discussing risk appetite tend to be technicians, not people with expertise about how we think about risks. We end up in a debate about what the model should look like.”*

Promoting richer strategic discussions and clarity on key issues

While bank strategies have always been rooted in risk management, formalized risk appetite statements have now become the primary driver of strategy discussions. One director stated, *“We see risk appetite as driving strategy – it is a constraint. It is not that you can develop a strategy and then risk appetite falls out of that,”* instead, risk appetite provides the parameters within which the strategy is set. Another director gave a specific example of how risk appetite impacts strategy and vice versa. This director noted that earnings growth targets were already part of the bank’s strategy, but through risk appetite discussions the board and management determined there could be opportunities to grow earnings more quickly and remain within the risk appetite. That, in turn, led them to embed earnings growth within the risk appetite. These kinds of debates have provided a framework for strategic decisions that have led some banks to make dispositions or exit businesses as a result.

This strategic dialogue is where directors see real value, not in perfecting models. One director predicted, *“The test will come in the next crisis: will the guy who got the gold star for having the best risk appetite model perform better? I doubt it.”* Instead, risk appetite is *“an iterative process; it is never perfect.”* Thus, it is discussed at virtually every risk committee meeting and regularly with the full board.

Driving risk appetite through the risk framework and into the business

There are still a number of issues that bank risk organizations are addressing as they implement risk appetite frameworks across huge organizations. Mr. Prybylski outlined some of them:

Banks are pulling more and more granular risk measures into the risk appetite, like stress tests, reverse stress tests, potential exposures. There is recognition that you need different metrics for different businesses and exposures, so [value at risk] is a useful metric for trading, but not necessarily for country

⁴⁰ Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* (Basel, Switzerland: Financial Stability Board, 2010), 13.

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exposures. This is producing more clarity regarding risk limit overages, approvals, and what needs to be escalated to the board.

Despite signs of progress, many banks still struggle to track and report on adherence to risk appetite: in a recent Ernst & Young survey, just 37% of respondents reported a strong ability to do so.⁴¹ Mr. Prybylski observed that is often unclear if risk appetite is consistently applied to other areas of the risk framework beyond limits to new product reviews, compensation, and business unit performance. Participants in the BGLN and at the summit highlighted several areas of focus regarding the evolution and implementation of risk appetite processes:

- **Integrating operational risk issues.** A director stated, *“We are not spending enough time on operational risk.”* To highlight the potential impact of operational risks, directors cited examples of rogue traders, which have prompted banks to look more closely at internal access and approval processes, and how personnel moves and changes are handled. A continuing challenge is establishing clear metrics for operational risks in the risk appetite statement. Mr. Prybylski noted, *“To apply risk appetite to operational and reputational risk issues is a challenge many banks are trying to address.”* Unlike financial risks, which generally have active mitigation plans, operational and compliance risks can be more difficult to mitigate, and setting a risk appetite without a mitigation plan presents a challenge.
- **Embedding risk appetite in the businesses.** Mr. Prybylski described the kinds of questions many directors are asking: *“How does risk appetite cascade down into the overall risk framework? How do you push this into business units, entities, so we are comfortable that we won’t exceed risk limits?”* While greater integration of risk appetite with risk limits and tolerances throughout the organization remains a priority, directors are pleased with the progress they have seen.

One director reported, *“Initially, I questioned our ability to embed [risk appetite] within the organization, but to my surprise it has become embedded. The risk dashboard has become a metric for the risk appetite framework. The business units know the CEO is interested, and the metrics that support the strategy get reviewed at the risk committee and board meetings.”* Another said, *“It is encouraging to see it down in the organization being used as a management tool, creating innovation too. It is about the business-line owners versus a corporate-level process.”*

- **Correlating and aggregating risks across businesses.** Linking risk appetite to risk limits and aggregating across businesses and legal entities while understanding the correlation between risks is a challenge for large, global banks. This challenge may become more complicated given the regulatory focus on resolution plans and legal-entity governance.
- **Linking risk appetite to dynamic capital planning.** One way for firms to deal with the current intense downward pressure on returns on equity is to more dynamically reallocate capital, taking into account the firm’s changing risk profile, market, and client opportunities. A director noted, *“It is linked to risk appetite because if capital is a scarce resource, becoming more so, we need mitigants to*

⁴¹ Ernst & Young, *Making Strides in Financial Services Risk Management* (Ernst & Young Global Limited, 2011), 25.

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reduce risk-weighted assets.” Mr. Prybylski asked, “Return on regulatory capital: what is the business model? It is putting pressure on financial planning and analysis ... The concern is that there will be even more trapped, unallocated capital.”

Instilling and monitoring risk culture

Directors often emphasize the importance of establishing the appropriate risk culture in an organization to truly embed the risk appetite: without it, even a complete set of risk controls may prove ineffective. Yet much of the effort in recent years have focused on formalizing risk appetite statements and linking to risk limit structures. Now, the challenge of establishing a risk culture, monitoring it, and giving it real meaning beyond platitudes is increasingly a priority. Boards have a central role to play in setting the appropriate tone at the top and ensuring the right messages are being communicated throughout the organization. One director said, *“Risk is not a function, it’s an attitude. It must start with the board, the CEO, and then you get down into metrics.”*

Directors can set the right tone regarding the balance between risk and return. One director explained, *“Risk appetite is about risk-adjusted returns. Where the board plays a role is guiding management, e.g., saying, ‘We don’t expect you to hit the expected return right now because we need to focus on the risk side and not get hung up on the return side.’”* Similarly, summit participants said that it is important to focus on unexpected outperformance as much as underperformance, and it needs to be clear, for example, that traders who exceed their limits are penalized the same way whether they make money or lose it: *“It is interesting to hear the commentary regarding the rogue trader stuff, that there is a perception that if someone produces unexpected profit, that is good. That perception needs to be culturally dismissed.”*

Summit participants outlined several ways that they can set and monitor risk culture:

- **Ensuring the stature and independence of the risk organization.** It is important that the chief risk officer and the risk team have appropriate stature within the organization. A director commented, *“We had to elevate the stature of risk managers, including compensation, sitting side by side with traders on the trading floor.”* Another said, *“We took one of the best people we had in the world and made him head of risk management, and he filled the organization with higher-quality people.”* It is also essential that they have the support of the CEO and are independent from the business lines.
- **Determining whether messages are effectively delivered and received.** Often, the officially communicated messages and policies can be different from the implicit messages being delivered to revenue producers, so management and the board need mechanisms to understand whether employees are receiving the right messages across the organization. One director said his bank had adopted a novel approach: *“We have employed a behavioral psychologist in our internal audit department. Do messages get consistently driven down?”* Another observed, *“What gives us comfort is seeing risk concepts in the strategic plan, in HR goals, in what management is using to manage the company.”*
- **Establishing clear value statements and linking them to compensation.** A director emphasized the importance of setting the right values and ensuring they are adhered to by tying them to performance evaluations and compensation: *“To reinforce it, we put together values and connected them to personal*

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objectives. You don't even get into the balanced scorecard for compensation purposes if you are outside of the values. That concentrates peoples' minds."

- **Monitoring behavior.** Ultimately, according to one participant, *"The question is, how has behavior changed?"* Directors and risk professionals are increasingly identifying behaviors – such as how issues are elevated and how management reacts – which are easier to monitor and can serve as signals of broader cultural issues.

Banks are focusing more on their ability to react quickly to stress scenarios

Regulators have used stress tests as an important indicator of banks' strength and resiliency and in many countries have prescribed specific tests to check banks' ability to withstand stress scenarios. Sovereign debt issues, especially in Europe, have prompted a new round of stress tests from the European Banking Authority.⁴² While stress tests remain an important tool, one participant said, *"Stress testing is just an indicator."* Thus, summit participants are increasingly focused on how their organizations have reacted to real events and how well prepared they are to react to subsequent events. Regulators are often looking for something with horizontal equity that can be applied to all banks under their supervision: *"Usually, regulators are trying to create a standard-model response instead of understanding how you reacted to all the things that have happened around the world."*

Some directors still struggle with the relative value of stress tests. One commented, *"We could all think of a thousand stress tests. Which will be helpful?"* Another asked, *"How do I know whether the stress is sufficiently acute? ... If one of our major counterparties went down, could we, in real time, identify our exposures? I don't think most could. So until I know which risks I need to protect against, how do I know what information I need?"*

These kinds of questions have led some to the conclusion that focusing on specific risks or causes of stress is less the issue than how the institution could react to any given stress scenario. A director stated:

Stress tests, by definition, are incomplete. The last five years have been real-time stress tests and you can observe what happened. So [knowing] how quickly the organization can react is more useful than modeling a static scenario. You have to extend beyond that. For example, if you test the cost of oil going up dramatically, you have to consider the impact on other industries, etc., not just the direct exposures, so it would be a huge test to run. So, rather than focus on that, focus on the agility to respond.

Another director described how this approach has changed the nature of board discussions: *"We spend much more time on liquidity management – when something goes wrong, will we have the cash to withstand it?"* Others have focused on adjusting their approach to stress tests, avoiding static scenarios to *"try to make the stress tests dynamic, looking at the primary, secondary, and tertiary effects."* Mr. Prybylski suggested, *"One approach is to ask management to respond [to the question], 'What would you do to react if a variety of*

⁴² *"Cushion calculations," Economist*, October 15, 2011.

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events happened?’ This can spur more of an open dialogue with management about exposures versus just the risk group doing stress testing.”

Banks have improved risk reporting but must address underlying IT issues

Banks have given significant attention on improving their ability to aggregate and report risk data to management, the board, and regulators. Many have done so by manual intervention and short-term fixes of legacy systems, often out of necessity, given limited resources and time to improve the underlying systems. Increasingly, however, banks acknowledge the need to address the broader underlying IT investment to drive better information management across their organizations.

Late in 2010, the regulatory community stressed the importance of risk appetite work and the associated IT issues. The Senior Supervisors Group made the following observation: “Most firms ... have begun multiyear projects to improve IT infrastructure ... but considerably more work is needed ... Aggregation of risk data remains a challenge for institutions, despite its criticality to strategic planning and decision making.”⁴³

Indeed, the findings of the abovementioned Ernst & Young survey support the group’s concern: more than 80% of respondents said that inefficient, fragmented systems made it hard to extract and aggregate data across the firm for stress-testing purposes.⁴⁴

The demand for companies to quickly produce aggregated risk information, respond to regulatory requests, or better understand risk exposures internally has underscored the need to improve IT systems. A director asked, *“How do we make our systems better for the business and also respond to regulators? The problem is that the information the regulators want doesn’t always align with business priorities.”* Summit participants discussed how to effectively address the challenge; it may require more than piecemeal improvements to risk systems, and banks need to consider front-to-back, multiyear risk and finance data system improvements to quickly produce aggregated data and serve multiple objectives.

Mr. Prybylski described the scale of the challenge to better manage risk information: *“Banks lack scalable finance and risk data processes ... The future has to be more flexible, with quicker access. Firms really need to look at front-to-back infrastructure to solve scalability issues versus an aggregation-process focus.”* This level of change includes substantial costs; as one director said, *“The numbers are huge.”* Mr. Prybylski added, *“There is a lot of cost tied up. It requires a lot of reengineering and you need to know where the business model is going.”* But there could be cost benefits in the longer term if banks make the required investment. One director said, *“We are always behind what we would like to have as a platform. As you face cost problems, how much complexity can you have? Can the systems deal with the complexity? Do we want them as complex as we have been? It becomes a strategic issue.”*

As IT issues reach the level of strategic investments from which banks can derive potential competitive advantage, they are garnering greater board attention. A director said, *“We set up a separate board committee to spend enough time to really understand these issues.”*

⁴³ Senior Supervisors Group, *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure* (New York: Senior Supervisors Group, 2010), 14.

⁴⁴ Ernst & Young, *Making Strides in Financial Services Risk Management*, 30.

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Risk committees struggle to remain forward-looking

Many directors describe the risk committee's mandate as primarily forward-looking, as distinct from the audit committee, which looks backward. Pressure from regulators is requiring risk committees to carefully manage full agendas, so they must work with management to ensure they remain forward-looking and focused on core risk issues. A director said, *"Focus is a constant challenge. Regulators are insisting more comes to the board. We challenge management to summarize what they are really worried about and focused on to distill what the real issues are and what you need to have a dialogue about."* Directors said that more items are coming to the risk committee for review and approval, whether by rule or at the suggestion of the supervisor, to which a risk committee review does not add much value. One director said, *"The level of detail the committee must sign off on is unreasonable,"* while another said the level of approvals required by their supervisor was *"a complete waste of time."*

In some cases, directors said, because the risk committee adds little value in spending time discussing *"well-understood compliance items,"* it uses consent agendas or teleconferences to save meeting time for content discussions. A director said, *"I go through the agenda with management and say, 'Do this, move this off, don't spend more than five minutes on this, etc.' You need to work hard to control the agenda."* Others are spending more time ensuring the audit and risk committees are aligned, having the chief risk officer attend audit committee meetings or holding joint sessions of the two committees. Another emphasized the importance of articulating clear expectations of management and ensuring the risk committee and the board get the appropriate level of detail in the information that management provides: *"Management give the board what they think the board wants to receive. We can do better communicating to management."*

Banks are seeking better ways to identify and respond to emerging risks

Despite the work and progress made toward better risk management and governance, some directors expressed concern that banks still focus too much on the details and on responding to regulatory requests, rather than directing resources toward identifying and discussing emerging risk issues. Ultimately, all of this work should improve firms' ability to identify, monitor, and manage emerging risk issues. Directors are asking how they can better identify early warning signals, position themselves better in advance, and react more quickly when risks emerge.

Directors are not entirely convinced that banks are better positioned to spot emerging risks now than they were prior to the financial crisis. One said he had seen some improvement, but was guarded in his assessment: *"I do think we see aggregate risks to the enterprise better, but I am not sure we will see them sooner."* Another concluded, *"The jury is still out."* One director provided a more nuanced assessment: *"I think there are emerging risks that we are aware of, but we can't quite size them yet. For example, cyber crime and IT security, dark pools. Undoubtedly, there are unexpected things and I am not sure we would know where the weakest player would be."*

One director noted, *"Many organizations – the IMF, Bank of England, European Central Bank, etc. – produce annual risk analyses ... The issue is really about what you do with them."* But most participants agreed that there could be an opportunity to establish a sustained dialogue about emerging risk issues across

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banks and with regulators who have broad industry perspectives.⁴⁵ Said one, *“I think a forum could be very useful. For [chief risk officers] it could be very helpful to identifying emerging trends and risks.”*

Significant progress has been made in changing the way banks manage and discuss risk issues among management and the board. Risk appetite statements have facilitated more integrated risk and strategy discussions, and provided a platform for communicating about risk throughout the organization. Still, regulators and boards see room for improvement.

As banks are forced to better manage and allocate capital, look for opportunities to better manage risk and finance data, and respond to ongoing regulatory requests, boards need to consider the strategic investments required to build competitive advantage. Boards and risk committees must decide how far to invest in risk management and governance and how to determine the right balance between a useful investment in risk management and the costs involved. Given the work completed and the work ahead, how do directors know how much progress their institutions have really made to better identify, monitor, mitigate, and react to risks?

⁴⁵ For more on the banks' desire to discuss emerging risks, see Bank Governance Leadership Network, [“Taking Risk Governance from Satisfactory to Strong.”](#) *ViewPoints*, August 1, 2011.

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Implications for banks: focus on growth and profitability levers

Old business models are gone: there is no more prop trading, no more miraculous products driving profitability. You need a solid business case. The future is [profit and loss] and balance sheet efficiency. – Summit participant

The stiff regulatory, political, and economic headwinds banks currently face prompted a discussion on the performance implications for banks at this year's summit. Throughout the course of the summit, participants discussed their views on the external economic conditions in Europe and the United States, as well as the likely impact that these economic conditions and new regulation will have on their banks' through-the-cycle returns on equity (ROEs) and the industry structure. They also outlined the growth and profitability levers that their banks must use to counter the external conditions and regulatory onslaught. None of the options are easy, but as one supervisor said after the summit, together, these levers may constitute "minimum survivor strategies." Indeed, some regulators believe bank boards and executive teams should be considering more radical change.

Directors look past the clouds to better economic news in Europe and the United States

In considering the global economic outlook facing their banks, directors see some real dangers ahead. Continued political gridlock in the United States over long-term fiscal policy, among other issues, remains deeply worrisome, as does the prospect of a double dip in the US economy. Similarly, the European Union's (EU) failure to successfully resolve member nations' sovereign debt crises is a cause of great concern, particularly if contagion fears are not addressed. The interconnectedness of banks magnifies these concerns.

However, despite those sobering realities, summit participants took some solace that the situation is better than it was three years ago, when many feared the world was on the precipice of a global depression. One director said, *"We are better positioned and prepared than in 2008. A huge amount of progress has been made."* To a great extent, this progress relates to the underlying resiliency of the banks. Another director observed, *"Safety and soundness [are] much improved in the last 12 months. Liquidity has improved drastically [and] capital is up."* A summit participant added, *"Banks [and] hedge funds are far less levered."*

Directors also observed several positive factors about the European and US economies that, despite their current anemia, bode well for continued recovery and eventual growth:

- **With a firewall, the world can weather the eurozone sovereign debt crisis.** Most of those present at the summit agreed that, ultimately, the Greek debt crisis is manageable. As one participant said, *"Greece will default; it is just a matter of time. The world can handle it."* One director noted, *"We will find solutions, even if Greece goes bust."* In part, this perspective is based on the fact that, as one participant observed, *"Italy and Spain do not have a solvency issue."* But there is also an assumption that governments will *"create a firewall"* between the Greek debt default and the other economies. The European Central Bank may play a major role since it has *"unlimited ability to lend against sovereign debt,"* if it so chooses. Directors also felt that political pragmatism will set in: *"[Eurozone members know] they must save the sovereigns to keep the euro afloat."* Participants agreed that without a firewall, on the other hand, Europe could plunge into *"a huge recession,"* with

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catastrophic consequences for the world. The ongoing political discussions in finding a lasting solution to the debt crisis support the directors' view.

- **Productivity has improved, and corporate balance sheets are healthy.** One director said of Europe, *“Cash is waiting to be invested again because corporates are very strong.”* The same is true in the United States: *“The US corporate world is in great shape.”* Directors recognize, however, that corporate leaders remain cautious about investing, because of continuing economic concerns and the political situation around the globe. One director said, *“There are some signs of life in the US economy. We are poised for recovery, if the politicians would let us do it.”* Another summit participant concurred, noting, *“Everyone is worried about political risk. I think it’s true in Europe and parts of Asia. Corporate guys want to see real reform: tax, immigration policy, etc.”*
- **The US housing industry may have bottomed out.** Given the US housing market’s central role in the financial crisis, it is not surprising that summit participants discussed its prospects. One participant said, *“The housing market is the answer to getting our economy back on track or bringing balance to whatever it is going to be.”* Directors were not predicting any near-term rebound in the US housing market (or, for that matter, in other markets that experienced material housing market failures in recent years), but one summit participant expressed a positive view: *“Most mortgages have already been written down. The distressed inventory is decreasing. Affordability is up ... jobs and recovery are linked ... [Once we clear inventory], we’ll see building, then more jobs. We will see it take off.”*

Directors expect lower returns and continued movement of operations to the United States and Asia

In light of regulatory and economic pressures, directors discussed likely ROEs for the industry. At last year’s summit, directors concluded that through-the-cycle ROEs would be in the 8%–12% range, with a noteworthy variance around the mean. Few at this year’s summit expect higher returns than these, but neither are their views more pessimistic than a year ago, even though their banks face continued market instability, new Basel III capital rules, and possible structural reform (whether directly or implicitly, through subsidiary-level capital and liquidity requirements). That said, one participant did indicate that regulatory change *“is having a huge negative impact.”* The participant said, *“[Our banks] are looking at budgets ... Dodd-Frank, SIFIs, etc. We are navigating all of that and [must] be prepared for surprises.”*

Expressing a view shared by many directors, one director said, *“We are used to double-digit ROE, trading at multiples of book value. Now, we have single-digit ROE, trading 50% below book or less. It is legitimate, post crisis, to expect lower ROE; 20%–30% was not sustainable. Insurance is typically 10%–15%, industrial companies around 10%.”* Summit participants wondered what type of banking sector regulators and politicians are aiming for, from a returns perspective. Noted one director:

There is a public policy question: what do the policymakers want the system to look like once they’re finished with it? If you look at Hong Kong, Singapore, China, banks are strong; they have strong capital, but the system is engineered in a way that encourages them to grow risk and take risk. You

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need to allow the system to make a return on equity. Policymakers don't care that banks are trading at half book, but as a result, there is no capital that wants to come in. In Europe, banks are making 6% or 7% ROE. Getting to 10% would be good.

This comment is indicative of bank directors' growing concern over attracting new capital. Adhering to new Basel III rules and further recapitalization of some banks in Europe, when it comes to pass, will strain the supply of new capital. One participant said, *"If the objective is for banking to be more of a utility, can shareholders be convinced to accept a lower rate of return? If no capital enters, then margins need to widen to attract capital."* Another director agreed, saying, *"Single-digit [returns are] not enough."* Yet it remains unclear what types of returns will be required. One director asked, *"If you take into account the huge losses the industry incurred, what are the returns we should look for in the future?"*

Summit participants also discussed the broader impact of reform on the industry. Taking up last year's dialogue on how businesses will move geographically, many directors suggested that operations would continue to move away from London and Europe more generally. Noted one director, *"Wholesale banking will become solidly international, and activities will move where the costs are lowest ... If the US and China set lower requirements, activities will move there. It's not regulatory arbitrage; it's just business sense. Wholesale activities will move out of Europe."* Another director said, *"The Tobin tax⁴⁶ will accelerate it."* By contrast, many directors agreed that *"retail will remain in-country."*

Trends in corporate banking will also be important. One participant predicted that *"corporates will consolidate with bigger banks,"* which will likely benefit global SIFIs. Several directors wondered if the recent move by Siemens to remove €500 million from a French bank and deposit it in the European Central Bank⁴⁷ is a sign of the future or simply a one-off. More broadly, several directors wondered if the drift of banking activities to the United States and China would precipitate, over time, a move of corporate headquarters from the United Kingdom. Said one, *"As the two superpowers [come to] dominate banking, corporate headquarters will follow."*

Bank directors and management teams should focus on growth and profitability levers

Given that the regulatory and economic environment will remain challenging for the foreseeable future, summit participants concluded that both bank directors and bank management teams must put aside yearning for bygone days of less capital, greater leverage, and high-margin products and must proactively seek out opportunities to improve revenue growth and profitability. Summit participants identified seven ways to do so:

- 1. Develop strong business rationales for existing businesses.** BGLN discussions over the past few years have revealed that for too long, the profitability of certain businesses, services, or products was not sufficiently scrutinized. Either the business case was weak, or capital was not properly charged to the activity. This is changing. One director said, *"Old business models are gone: there is*

⁴⁶ The Tobin tax is an excise tax on cross-border currency transactions. The European Commission recently proposed such a tax for securities transactions over certain thresholds undertaken by financial institutions based in the European Union.

⁴⁷ Daniel Schäfer, Chris Bryant, and Ralph Atkins, *"Siemens Shelters up to €6bn at ECB,"* *Financial Times*, September 20, 2011.

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no more prop trading, no more miraculous products driving profitability. You need a solid business case. The future is [profit and loss] and balance sheet efficiency. Ask the CFO, ‘What kind of return do we achieve on an asset-by-asset basis?’” Many banks have already made changes, large and small, to their business portfolios, and more are expected. One participant remarked, *“We may need to restructure.”*

- 2. Radically reduce costs.** Banks will have to consider material changes to their execution models, well beyond the headcount reductions that have already been announced globally. One director said, *“The industry is inefficient, so driving efficiency is probably part of [the answer].”* Another director agreed, saying, *“The focus will be on cost, which is probably a good thing.”* One director said that *“deeper cuts”* in costs are needed to make a real difference: *“not 5%, but 15%–20% of costs.”* This will require some creative solutions, such as the mix of bricks-and-mortar and online or smartphone delivery, along with major investments in information technology to drive out redundancies (and also reduce operational risks).
- 3. Deploy capital more dynamically and efficiently.** Much of the discussion to date on capital has focused on how increased capital requirements and trapped pools of capital or liquidity are a drag on performance and cause economic inefficiencies within banks and in the economy. This year’s summit discussion also focused on what to do about inefficient capital usage in this context. One director said, *“Capital management [will become more important]. [Capital] is a scarce resource, so how do you drive risk-adjusted returns? We cannot accept 10%–20% of capital allocated to unprofitable businesses anymore. We need to drive sustainable, risk-adjusted returns for all capital.”* Another participant said, *“We are restructuring and reconsidering assets, the risk they pose, and the capital you need against them.”* A third said, *“We are going to know everything [we can] to squeeze every bit of capital [for returns].”*
- 4. Redesign service delivery, create strong brands, and set prices appropriately.** As the discussion on customer and client issues showed, banks have real opportunities to outperform peers by meeting clients’ needs with unique, strong offerings at prices designed to appeal to targeted consumer segments, while also being profitable. One participant said, *“We can do innovative things to reprice and repackage.”* This will likely require syndicating capital-intensive parts of the business system, while making a profit on client relationships through service and origination. In addition, many accept that banks with good brands can take volume from others, and in practice global SIFIs may gain clients and customers in a flight to quality and safety.
- 5. Develop new business models.** The dialogue on profitably servicing customers and clients also highlighted the need to consider major shifts in bank business models. The most visible examples today are changes in credit card and checking account fees. In addition, some institutions are testing new approaches to charging for corporate deposits and other services. One director said that banks *“should think of how we [can] try and reshape a new model”* in many areas. There was a general sense that the problems the industry faces have not crippled its ability to innovate. *“Even in a deep crisis, there is always an opportunity,”* noted one director.

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6. **Capture growth opportunities in emerging markets.** Although some countries and regions are dealing with significant economic and political woes, others remain strong. As one director put it, *“The good news is that the economic problems are concentrated in half of the global GDP: the EU and the US ... Canada and Australia did well. Latin America, Asia, Africa are still growth areas.”* Another director stated confidently, *“China will do what [it] can to empower a healthy economy as the new leader comes in.”* While directors know that many foreign banks have struggled to reap the expected rewards from emerging markets, one participant noted that *“many of these countries are getting better and better at being pro-business.”*
7. **Make material changes to compensation levels.** Directors emphasized that significant structural changes have been made to compensation, notably by instituting more deferrals, risk-adjusted pay, and tougher clawbacks. Generally, these changes are positive, although they can put larger banks at a competitive disadvantage compared with other financial institutions, especially in Europe, where laws have been more stringent. However, compensation levels have not changed materially. One director said, *“The interesting thing is, in past cycles, the industry has taken the axe to remuneration. Not so this time so much. [Increases in remuneration] may be slowing this year, but there is very little sign of pressure.”*

Indeed, many directors agreed with one participant’s view that *“the continuing challenge with compensation is that it is a cross-border market for talent, especially in functions like risk that are growing. If anything, there is upward pressure on compensation in those.”* The same is true in Asia, many reported. In the context of significantly reduced ROEs, this is problematic. One director noted, *“Compensation has been higher than in other industries. At some point, we need to balance that with the return to shareholders. Even with higher productivity and cost savings, ultimately, there will be continued strain on the ability to compensate at levels that are substantially different than the rest of the economy.”* The contradictory pressures on compensation appear, at this point, to be irreconcilable. Despite the strong rationale for reducing compensation, the continuing war for talent makes cutting compensation difficult and exposes those who do cut back to the risk of real talent losses.

Regulators encourage boards to consider more radical change

If banks employ all of these levers, will they have done enough? Many directors consider the above recipe for change to be very demanding and a real step change in their bank’s current approach. But do regulators agree? Some regulators believe bank boards and management teams still have not yet truly grasped the ramifications of the changes that are afoot globally. Speaking after the summit, one supervisor challenged bank boards to think more radically. The supervisor asked directors to imagine three possible scenarios:

- “Balkanization by regulators could kill many cross-border, cross-currency businesses. For example, European banks relying on US money market mutual funds for funding – [imagine if] regulators [wouldn’t] allow it.”
- “Government guarantors of SIFIs will [permit] exposure to only low-volatility business lines.”

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- “Overcapacity in the systems forces massive consolidation in banking.”

In this context, focusing on profitability levers seems necessary, but distinctly insufficient. Bank boards and management teams have some real thinking to do over the next few years and beyond.

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Bank directors concede that, for the foreseeable future, their institutions face significant regulatory, economic, and political headwinds. The European and US economies provide daily reminders of their fragile conditions. Regulators continue to tighten the screws on banks. Depressed ROEs will be difficult to reverse.

Yet to attract talent and investors, banks must spend less time explaining why new regulatory requirements and economic conditions impair returns and more time on the levers of growth and profitability that are within their reach. While banks may be unable to tackle compensation at the moment, they can still benefit from making material changes to portfolios, operations, and the customer experience. Greater discipline in managing assets and capital is also of paramount importance. Even with regulators hinting that greater changes might be necessary, directors must still take these steps. It is the only way forward.

About this document

The Bank Governance Leadership Network (BGLN) 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 white paper. Ernst & Young sponsors the research as part of its deep, continuing commitment to board effectiveness and good governance.

ViewPoints aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Anyone who receives *ViewPoints* is encouraged to share it with those in their own network. The more board members, members of senior management, advisers and stakeholders who become engaged in this dialogue, the more value will be created for all.

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Appendix 1: 2011 Bank Directors Summit participants

Directors

Bank of America

- Donald E. Powell, Audit Committee Member, Compensation and Benefits Committee Member, Executive Committee Member

Bank of China

- Jackson Tai, Audit Committee Member, Connected Transaction Control Committee Member, Strategic Development Committee Member

Barclays PLC

- David G. Booth, Risk Committee Chair, Corporate Governance and Nominations Committee Member

BNY Mellon

- Catherine A. Rein, Audit Committee Chair, Corporate Governance and Nominating Committee Member, Executive Committee Member

CIBC

- Ronald W. Tysoc, Audit Committee Chair, Corporate Governance Committee Member

Credit Suisse

- Jean Lanier, Audit Committee Member, Compensation Committee Member

Deutsche Bank

- Karl-Gerhard Eick, Audit Committee Chair, Supervisory Board Member

HSBC

- Douglas J. Flint, Group Chairman

ICBC

- Sir Callum McCarthy, Strategy Committee Member, Risk Committee Member, Nominations Committee Member

JPMorgan Chase

- Laban P. Jackson, Jr., Audit Committee Chair

Macquarie Group

- Peter H. Warne, Risk Committee Chair, Audit Committee Member, Corporate Governance Committee Member, Remuneration Committee Member

Morgan Stanley

- Roy J. Bostock, Nominating and Governance Committee Member, Risk Committee Member
- Donald T. Nicolaisen, Audit Committee Chair, Compensation Management Development and Succession Committee Member

Rabobank

- Marinus Minderhoud, Audit, Compliance and Risk Committee Chair, Supervisory Board Member

Société Générale/Unicredit

- Anthony Wyand, Vice President of the Board, Audit, Internal Control, and Risk Committee Chair, Nomination and Corporate Governance Committee Member, Compensation Committee Member, Société Générale; Internal Control and Risks Committee Chair, Permanent Strategic Committee Member, UniCredit

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TD Bank

- Wilbur J. Prezzano, Human Resources
Committee Chair, Risk Committee Member

UBS

- Axel P. Lehmann, Risk Committee Member

U.S. Bancorp

- Olivia F. Kirtley, Audit Committee Chair,
Executive Committee Member, Governance
Committee Member

Guests

- Andrew Bailey, Deputy Head of the
Prudential Business Unit, Director of UK
Banks and Building Societies, Financial
Services Authority (FSA)
- Sarah J. Dahlgren, Executive Vice President,
Financial Institutions Supervision Group,
Federal Reserve Bank of New York
- Jamie Dimon, Chief Executive Officer and
Chairman, JPMorgan Chase
- Elizabeth A. Duke, Member, Board of
Governors of the Federal Reserve System
- F. Edward Price, Deputy Superintendent,
Office of the Superintendent of Financial
Institutions (OSFI)

Ernst & Young

- Andy Baldwin, Sub-Area Managing Partner,
EMEIA Financial Services
- Carmine DiSibio, Vice Chair and Managing
Partner, Financial Services
- Stephen R. Howe, Jr., Americans Managing
Partner, Member Global Executive Board
- Marcel van Loo, Banking & Capital Markets
Leader, EMEIA Financial Services

- Lawrence Prybylski, Global Practices Leader,
Financial Services Risk Management
- William Schlich, Global Banking & Capital
Markets Leader, Financial Services

Tapestry Networks

- Dennis P Andrade, Senior Associate
- Christopher B. McDonnell, Principal
- Mark Watson, Partner
- Thomas M. Woodard, Partner

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Appendix 2: Interviewees

Since early 2009, Tapestry Networks and Ernst & Young have been leading an initiative, the Bank Governance Leadership Network (BGLN), which brings together directors and executives (notably chief risk officers) from leading global banks, and key regulators and supervisors, to discuss the ongoing challenges confronting their institutions. Approximately 200 individuals currently participate in the network, as well as over 80 Ernst & Young professionals. Participants engage in ongoing discussions with Tapestry Networks and Ernst & Young throughout the year so the network meetings enable focused dialogue on areas where progress can be made. The third Bank Directors Summit was the 16th BGLN meeting since its inception. This *ViewPoints* draws on dialogues with over 120 BGLN participants and includes discussions from seven BGLN meetings, over the course of 2011. In addition to the summit participants, the list of individuals who attended BGLN meetings this year, and who engaged in one-on-one dialogues on the key issues, includes:

Directors and executives

Bank of America

- Susan Bies, Audit Committee Member, Enterprise Risk Committee Member

Barclays PLC

- Sir Richard Broadbent, Former Senior Independent Director, Deputy Chairman, Corporate Governance and Nominations Committee Member, HR and Remuneration Committee Chair
- Alison Carnwath, Audit Committee Member, HR and Remuneration Committee Member
- Lawrence Dickinson, Company Secretary
- Simon Fraser, Audit Committee Member, HR and Remuneration Committee Member
- Dambisa Moyo, Risk Committee Member

BNY Mellon

- Nicholas Donofrio, Risk Committee Chair, Executive Committee Member, Corporate Social Responsibility Committee Member
- Brian Rogan, Vice Chairman, Chief Risk Officer

CIBC

- Gary Colter, Corporate Governance Committee Chair, Management Resources and Compensation Committee Member
- Nicholas Le Pan, Risk Management Committee Chair, Corporate Governance Committee Member
- Tom Woods, Senior Executive Vice President, Chief Risk Officer

Citigroup

- Michael O'Neill, Director, Chairman of Citi Holdings Oversight Committee and Member of Risk Management & Finance Committee
- Anthony Santomero, Risk Management and Finance Committee Member, Audit Committee Member
- Diana Taylor, Nominations, Governance, and Public Affairs Committee Chair, Personnel and Compensation Committee Member

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Credit Suisse

- Tobias Guldemann, Chief Risk Officer, Executive Board Member
- Anton van Rossum, Risk Committee Member
- John Tiner, Audit Committee Chair, Chairman's and Governance Committee Member, Risk Committee Member

HSBC

- John Coombe, Non-Executive Independent Director, Audit Committee Chair, Risk Committee Member, Remuneration Committee Member
- Marc Moses, Group Chief Risk Officer

ING

- Koos Timmermans, Former Chief Risk Officer, Executive Board Member

JPMorgan Chase

- Sally Dewar, Managing Director, Risk
- Barry Zubrow, Chief Risk Officer

Lloyds Banking Group

- Lord Alexander Leitch, Non-Executive Director, Deputy Chairman, Audit Committee Member, HR and Remuneration Committee Member, Nominations and Governance Committee Member
- David Roberts, Risk Committee Chair

Macquarie Group

- Stephen Allen, Head of Risk Management Group
- Michael Hawker, Audit Committee Member, Risk Committee Member

Morgan Stanley

- Martin Cohen, Managing Director and Corporate Secretary
- Sir Howard Davies, Risk Committee Chair, Audit Committee Member
- C. Robert Kidder, Lead Director, Compensation Management Development and Succession Committee Member, Nominating and Governance Committee Member

Rabobank

- Pieter Emmen, Director, Group Risk Management

RBC

- Morten Friis, Chief Risk Officer

RBS

- Nathan Bostock, Former Head of Restructuring and Risk
- Sir Sandy Crombie, Senior Independent Director, Group Sustainability Committee Chair
- Sir Philip Hampton, Chairman

Société Générale

- Benoît Ottenwaelter, Chief Risk Officer
- Nathalie Rachou, Audit, Internal Control and Risk Committee Member

TD Bank

- Mark Chauvin, Chief Risk Officer
- Brian Levitt, Chairman of the Board, Corporate Governance Committee Chair, Human Resources Committee Member
- Harold MacKay, Risk Committee Chair, Audit Committee Member

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UBS

- Maureen Miskovic, Group Chief Risk Officer, Group Executive Board Member
- David Sidwell, Senior Independent Director, Risk Committee Chair, Strategy Committee Member

UniCredit

- Karl Guha, Chief Risk Officer, Executive Management Committee Member

U.S. Bancorp

- Richard Davis, Chairman, President, Chief Executive Officer
- Richard Hidy, Executive Vice President and Chief Risk Officer
- Jerry Levin, Compensation and Human Resources Chair, Executive Committee Member, Governance Committee Member

Wells Fargo

- Michael Loughlin, Executive Vice President and Chief Credit and Risk Officer

Westpac

- Greg Targett, Chief Risk Officer

Regulators, supervisors, and policymakers

Australian Prudential Regulation Authority

- Heidi Richards, General Manager, Diversified Institutions Division
- Ian Laughlin, Member

Bank for International Settlements

- Jaime Caruana, General Manager

Basel Committee on Banking Supervision

- William Coen, Deputy Secretary General, Basel Committee on Banking Supervision
- Neil Esho, Senior Member of Secretariat, Basel Committee on Banking Supervision
- Stefan Walter, Secretary General, Basel Committee on Banking Supervision

China Banking Regulatory Commission

- Liu Mingkang, Former Chairman, China Banking Regulatory Commission

Federal Financial Supervisory Authority (BaFin)

- Claudia Grund, Senior Advisor, Banking Supervision
- Ludger Hanenberg, Senior Director, Banking Supervision
- Frauke Menke, Executive Director, Banking Supervision

Federal Reserve Bank of New York

- Michael Alix, Senior Vice President, Financial Institutions Supervision Group
- James Hennessy, Senior Vice President, Chief of Staff, Financial Institution Supervision
- Steven Manzari, Senior Vice President, Market and Liquidity Risk Department

Financial Services Agency

- Katsuhiko Komai, Chief, International Affairs Section, Inspection Bureau
- Akiko Nakamura, Inspection Bureau
- Kiyotaka Sasaki, Director, Inspection Coordination Division

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Financial Services Authority

- Clive Adamson, Director of Supervision, Business Conduct Unit
- Thomas Huertas, Former Head of International Division
- Rosalie Langley-Judd, Manager, Governance Policy, Prudential Policy Division
- Lyndon Nelson, Director, Risk Management Division
- Ian Tower, Head of Wholesale Banks & Investment Firms Department

Financial Stability Board

- Eva Hupkes, Advisor, Regulatory Policy and Cooperation, Financial Stability Board
- Costas Stephanou, Member of Secretariat, Financial Stability Board

Office of the Comptroller of the Currency

- Mike Brosnan, Senior Deputy Comptroller, Large Bank Division

Office of the Superintendent of Financial Institutions

- Jacqui Campbell, Manager, Corporate Governance Division
- Barbara Demone, Manager, Financial Conglomerates Group
- Gaetano Geretto, Senior Director
- Maria Moutafis, Director, Corporate Governance

Swiss Financial Market Supervisory Authority FINMA

- Mark Branson, Head of the Banks Division

UK Independent Commission on Banking

- Bill Winters, Member

Ernst & Young

- Chris Bowles, Partner, UK Financial Services Risk Management Lead
- Tom Campanile, Partner, Enterprise Risk management, Financial Services
- Stephen Christie, Strategy and Business Incubation Lead
- Stephen Gregory, Partner, Advisory Services, EMEA Financial Services
- Patricia Jackson, Head of Prudential Advisory Practice, EMEA Financial Services
- John Liver, Partner, Financial Services Advisory
- Christopher Maher, Principal, Financial Services
- Tim Rooke, Partner, Risk Advisory Services, EMEA Financial Services
- Donald Vangel, Advisor, Regulatory Affairs

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