Bank Governance Leadership Network
ViewPoints
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The future of global banking

> It may be time to shift from focusing on the implications of increasing levels of financial globalization, to a serious discussion of the implications of banking deglobalization. – Kristin Forbes, member of the Monetary Policy Committee, Bank of England[1]

On October 1–2, participants in the Bank Governance Leadership Network met in London for the sixth Bank Directors Summit. Discussion focused on the future of global banking.

After a period of international expansion, an optimistic vision of global banking developed during the 1990s: national borders would become less and less relevant, and money, ideas, and people would move around the world at great speed. Banks would achieve global scope and scale in order to serve corporations that were moving toward similar scope and scale.

The financial crisis and the regulatory response have meant the world in 2014 looks very different. Ian Goldin, professor of Globalisation and Development and director of the Oxford Martin School at the University of Oxford, wrote of the crisis, "A mismatch developed between a system that had become global in its reach and a regulatory structure still rooted in national institutions."[2] In that light, perhaps it is not surprising that global banks now face an environment of increasing nationalism. The *Economist* reported last year that "unfettered globalisation has been replaced by a more selective brand … [Governments] have not built impermeable walls, but they are erecting gates. That is most obvious in capital markets."[3] In a special report expanding on the topic, the *Economist* added, "Banks now face growing pressure to bolster domestic lending, raise capital and ring-fence foreign units."[4]

Some have predicted the demise of global banking as a result. At last year's summit, a director observed, *"Capital is defined by national boundaries and being trapped because it's measured by each country. Banks are now having trouble doing business outside their borders because capital is no longer fungible … I would argue we're seeing a disappearance, or downgrading, of international banking.*"[5]

To overcome the significant strategic and operational challenges the current environment poses, international banks are seeking means of achieving sustainable returns while simultaneously demonstrating to regulators and investors that they are not "too big to manage" and that their cultures do not encourage bad behavior.

At this year's summit, participants discussed the difficulties of attempting to make these transformations in bank structure and strategy while under increased scrutiny for conduct and compliance. They also considered the intention and impact of regulation and other forces shaping international banking.

This *ViewPoints* includes perspectives from discussions with BGLN participants in preparation for, during, and immediately after the summit. It is divided into the following three sections:

- **Regulation is driving changes to global banking.** International reforms have been under way for six years, and many policy decisions have been taken. A participant stated, *"Regulation is driving strategy at regulated institutions, especially across borders."* New regulations have become the single most important driver of changes to business models for large banks, both the most global and those that are largely domestic, but with international, diversified banks experiencing the greatest impact. Participants discussed the consequences – both intended and unintended – of regulation that are now becoming more apparent. *(Pages 4 – 12)*
- **Time for tough decisions: transforming global banks.** A key concept among bank strategists today is defining growth and return objectives, and developing sustainable models for achieving those. Large, international banks face particular challenges in reevaluating structures and models for delivering products and services in multiple markets. Participants generally agree that playing to areas of strength is a sound approach, but innovation will also be necessary. In particular, the threats and opportunities of digitization came under discussion, as well as the importance of having the right people in place to lead transformation efforts. *(Pages 14 – 22)*
- **Too big to govern? Expectations for bank boards continue to evolve.** The challenges of governance in the period immediately following the financial crisis gave birth to the BGLN. At last year's summit, participants concluded that heightened expectations for bank directors were here to stay. Since then, a number of conduct and compliance issues have emerged, even for banks that have reputations for being well managed and well governed. This has renewed questions about the governability of the largest, most international, and most complex banks, and the roles and responsibilities of group and subsidiary boards. *(Pages 24 – 31)*

These issues are explored in greater detail in the sections that follow. Many remain unresolved and will be the focus of BGLN discussions through 2015.

> Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning. – Sir Winston Churchill

The BGLN and the global regulatory reform process began at about the same time, and for the same reason: to deal with the unprecedented financial crisis of 2007 – 2008. Six years later, regulators and bank leaders are turning their attention toward implementing reforms. As a summit participant noted, *"The conceptual work on regulatory reform is only now coming to a close. The implementation phase is just beginning."*

"The conceptual work on regulatory reform is only now coming to a close. The implementation phase is just beginning."

– Participant

Reforms pursued two closely related objectives: reducing the likelihood that a large financial institution would fail, and, at the same time and with equal priority, avoiding the contagion effect of such a failure and thus forestalling a systemic event. Achieving these objectives has meant that reforms have aimed at both ensuring the prudential safety of individual institutions, through means such as stricter capital and liquidity requirements, and instituting structural changes to avoid contagion within multiline organizations and across the system. Many of these reforms have emphasized local operations: ring-fenced local capital and liquidity, local governance and systems, and national and cross-border recovery and resolution regimes.

As these reforms move into implementation, the combination of individual and systemic objectives is forcing banks to revisit business models and organization structures. A summit participant said, *"Regulation is driving decision-making for all banks, international and domestic,"* but the reforms aimed at avoiding international contagion are particularly challenging for global business models. Summit discussions focused on structural changes to global banks and on recovery and resolution planning.

Regulation is focused on avoiding negative outcomes, not on defining the desired system for international banking

BGLN participants have continually questioned the ultimate objectives of reforms. Prior to the summit, one director said, *"If you ask the FSB [Financial Stability Board], the Basel Committee, or national governments, I don't think they can articulate the policy outcome that they are seeking; they aren't actively trying to do anything more than avoid the failure of a large institution."*

Regulators at the summit suggested there was no agenda to change global banking per se. According to one, *"I am not sure the aim of these regulations is to attack the global banking model. There is no hidden agenda to change or limit global banking … More constrained, yes, but there is no intention to challenge the concept of a global bank."* Another said, *"The focus has been on global banks because of their systemic importance."* It is nonetheless clear that there will be consequences, intended or not, for large, international banks: regulatory reforms seem inevitably to create a future of smaller, simpler, and nationally ring-fenced banks.

"There is no hidden agenda to change or limit global banking."

– Regulator

To ensure that the failure of an individual entity does not create contagion, policymakers have instituted reforms such as those recommended by the Independent Commission on Banking ("Vickers") in the UK, the Liikanen Group in Europe, and former Fed Chairman Paul Volker. These reforms are aimed at protecting retail and commercial banks from wholesale and investment banking activities, which the policymakers perceived as riskier.

Increasingly, regulators also are asking for locally capitalized entities with local liquidity, and empowered management teams and independent boards in each country. Robert McCauley of the Bank for International Settlements (BIS) warned, "Application in some jurisdictions of the newly agreed international bank liquidity standards and policies favoring subsidiaries over branches ('subsidiarization') could de-internationalize global banking in the sense of inducing banks to match assets and liabilities jurisdiction by jurisdiction."[6] He added, "The application of the Basel Committee's new liquidity standards carries more than the usual potential for fragmentation," noting that "a number of regulators have announced their intention to apply liquidity requirements to the subsidiaries and branches of foreign banks in their jurisdictions."[7] In addition, many of those requirements include restrictions on cross-border intragroup funding. Under rules adopted by the Federal Reserve last February, the United States, for example, is holding large foreign bank operations to the same prudential standards applied to US banks on a stand-alone basis via a rule requiring them to establish intermediate bank holding companies. This could challenge the sustainability of a centralized group model. A former regulator has claimed, "Subsidiarisation would be the end of international banking."[8]

"It is very hard to think that resolution will work, or that people have really thought through the implications of bail-in for investors."

– Director

Developing cross-border resolution regimes seems to be producing ancillary benefits

Discussing the status of international financial reform, a supervisor said, *"Resolution is the remaining piece of the reform agenda, and it is of great strategic importance."* Thought by many to be central to addressing the "too-big-to-fail" phenomenon, recovery and resolution planning is particularly likely to impact the organization and capital structures of large international banks. Andrew Bailey, chief executive of the UK Prudential Regulation Authority (PRA), said, "[Resolution planning] is where we will place emphasis when forming a view on our risk appetite towards branches operating in the UK. We will therefore expect assurance from the home state regulator over the recovery and resolution plans."[9]

Enduring questions

At the summit, a director commented, *"Resolution is a big issue for which we act as though we have an answer. It is convenient to believe there is an answer to too-big-to-fail. It is very hard to think that resolution will work, or that people have really thought through the implications of bail-in for investors."* A supervisor acknowledged, *"[Resolution] will not be solved next year, or the year after that. It will take time to get large banks to be resolvable."*

In August, regulators announced that 11 of the largest domestic and foreign banks operating in the United States had to address significant shortcomings in their draft resolution plans.[10] Regulators cited the firms' failure to reform their structures and practices in ways that could prevent the damaging effects of a large firm's bankruptcy.[11]

Thomas Hoenig, vice chair of the Federal Deposit Insurance Corporation (FDIC), criticized some of the draft plans for failing to acknowledge that countries would likely "protect their domestic creditors and stop outflows of funds when crisis threatens. Ring-fencing assets will be the norm not the exception."[12]

It is clear that iterations will continue. Part of the feedback from the Fed and the FDIC to the banks regarding their submitted plans was that institutions should not assume they would have access to the discount window in the event of a liquidity crunch. According to some commentators, this could lead to big changes for the banks: "Without government liquidity, most banks think they would have to set aside billions of dollars in cash as a cushion," which could "radically alter their balance sheets and shrink the availability of credit."[13]

Promoting simplification and informing decisions

Bank and regulatory leaders generally accept that the issue of resolution is far from solved. However, a supervisor observed, *"We have made progress. Going through the exercise was very helpful. We and the banks know better what the material legal entities are and where, and the dialogue is better."* Another maintained, *"[Recovery and resolution planning] is not designed to restrain growth, but to promote resolvability. There is nothing oriented to limit activities or shrink banks. The goal is to make them more maneuverable."* Another shared a similar view: *"Resolution planning is not intended to make parts of banking more or less viable. It is forcing better costing, better decision-making processes."*

Recovery and resolution planning, integrated with stress testing, is helping bank leaders think about strategic questions, such as how profitable a bank would be under different economic scenarios and what effect a change in strategy or in the economic situation would have on future capital requirements and liquidity. In addition, management and boards are considering how global restructuring could affect required capital and liquidity and how the sale of different portfolios could affect a bank's performance.[14] As a result, boards and management teams are gaining insight into decisions about where to invest or withdraw increasingly scarce capital.

"[Resolution planning] will involve choices for firms that probably should have been considered before now."

– Director

A director observed, *"It is forcing simplification, making the banks more credible with regulators and investors. You may still be complex, but you have more to prove as to why. This will involve choices for firms that probably should have been considered before now."* The process has also improved insight around the interconnectedness within banks, such as their reliance on infrastructure and systems across businesses that would be needed to maintain operations in the event of a recovery or resolution process.

Growing board engagement

Several directors said the discussion about resolution at the summit had caused them to think differently about the process, the degree to which the regulatory community is focused on the issue, and the role of the board in reviewing plans and their implications. Independent directors continue to consider how they can best add value, and what they need to do. One asked, *"What does a board do? Are we expected to read carefully all*

3,000 pages of the plan? Or should we focus on changes to the fundamental structure of the bank?" Management needs to highlight for boards the key assumptions and steps in the plans for boards to focus on.

Directors also question the degree to which this process should really drive strategic discussions. One asked, *"To what extent is preparing for our death going to define how we structure ourselves in life?"* But another suggested, *"[Recovery and resolution planning] is not so much about how you are going to die, but how you are going to live,"* and is therefore an important input, and potential constraint, to strategic board discussions about business models and structures.

Looking ahead

Even if the process of developing recovery and resolution plans does lead to less complex bank structures, implementation will not be easy. As one director noted, *"The more banks simplify, it will become nigh impossible to sell bits off. Resolvability may actually be reduced."* Another added, *"Banks are not necessarily easier to resolve with a subsidiary structure."* As a result, doubts remain about when and how this process will be completed. A lack of trust among regulators from different jurisdictions also challenges a viable cross-border resolution regime. A director stated, *"This all sounds nice in theory, but in practice, the level of trust and cooperation you need between regulators – we are a long way off from achieving that … The regulatory colleges are not as effective as people hoped they would be."*

"Subordinated debt holders now believe they are at risk, whether they are or not. That changes the cost of capital."

– Participant

Banks and regulators are not the only stakeholders who need to be engaged in the process. A participant contended, *"The most important next step is for the market to be convinced that there is something at the end of this process, and then it will recalibrate. Subordinated debt holders now believe they are at risk, whether they are or not. That changes the cost of capital."*

A supervisor suggested the process will move forward in constructive ways: *"Institutions are not resolvable today, but the process has started a dialogue. The resolution authorities will have tools related to the structures of banks; they need those without being satisfied that we have achieved resolvability yet."* International regulators will also need a better understanding of the potential for global contagion, even in the event of an effective large bank resolution. A supervisor said, *"Without that understanding, single point of entry cannot work. Politicians will get involved and national interests will prevail."*

Conduct and compliance issues are increasing the cost and risk of international operations

Andrew Bailey said in October, "We are in many ways in the second phase of the financial crisis. The first phase was a prudential one, while the second phase has revealed past misconduct. Fixing the financial system requires more than just fixing capital and liquidity standards. Standards of governance, conduct and the right incentives structures are all extremely important."[15] A director described the ever-growing concern over conduct issues: *"I am less concerned about capital requirements impacting profitability –*

we need a standard, however high …With conduct, however, there is a significant risk that it can be overplayed, and we could be doing things that will be judged not to be in the interest of customers."

Conduct issues are creating a number of issues for international banks:

Massive fines

Fines collectively totaling hundreds of billions of dollars, including individual bank penalties of $10 billion and more, have grabbed headlines over the last two years. BNP Paribas' agreement in June to pay almost $9 billion for violating sanctions demonstrated "a broader U.S. Justice Department shift in strategy that is expected to try to snare more major banks for possible money laundering or sanctions violations."[16] While many of the previous fines stemmed from infractions dating back years, a commentator noted recently, "The issue seems unlikely to fade. Several of Europe's biggest banks, including Deutsche Bank, Société Générale, UniCredit, Crédit Agricole and Commerzbank, have all disclosed that they face US regulatory scrutiny for sanctions-busting."[17] The scale of the fines, their extraterritorial reach, and the uncertainty generated on the local and national level by the involvement of a mix of regulators and other officials all add to risk for global banks.

Continuing uncertainty

A participant said, "Some of these fines are due to legacy issues, which are hopefully close to resolved, but I don't know where it ends. Some of this, like the [foreign-exchange benchmark-rigging scandal] is new. In terms of proportionality, there is just no way to make sense of it at all." Another asked, "Where is the inflation of fines leading us? We have competing forces now, where banks are exiting some markets due to draconian anti-money laundering and financial crime issues, but that is upsetting some governments and expatriate groups." In some cases, particularly in the United States, a director noted, "The uncertainty is more driven by other actors, like the Department of Justice, than it is the regulators." In fact, several prudential regulators have expressed concern about the escalation of fines and the potential damage that unlimited fines pose to efforts to rebuild the strength of the financial system.[18]

"If you cannot justify the cost of compliance for doing business somewhere, don't do the business."

– Director

Changing the risk/reward of global operations

Uncertainty and compliance costs are driving banks out of some markets. One director explained the way banks should approach the issue: *"It is possible to comply; it is just expensive. The compliance risk is higher, so the return better be higher. If you cannot justify the cost of compliance for doing business somewhere, don't do the business."* Another director said, *"We could see banks exit markets because the costs of compliance are such that the risk is unacceptable."*

Concerns about shadow banking continue to grow

Participants see a growing threat from non-bank competitors across a number of businesses, with accompanying concerns about the oversight and regulation of the financial system as activities shift into the unregulated world.

A director said, *"Core, middle-market credit is being taken out of banking [by peer-to-peer lenders and other non-bank competitors]."*

Directors continue to express frustrations about their ability to compete with companies unencumbered by the regulatory constraints that their institutions face. One asked, *"Are regulators satisfied that there is a level playing field on which banks are being asked to play with other entities?"* A regulator acknowledged, *"We have a big problem the more things move out of the regulated banking sector. It is difficult to supervise and control these activities if they move outside of banks, from consumer protection to [anti-money laundering] and terrorism financing, etcetera."* Another regulator said, *"Shadow banking has not been a focus, but that is now shifting. There has been an awareness, but we need different measures to address this."* Such measures include clarity around mandates and who has, or can be given, responsibility for oversight of these institutions and activities.

"For the first time in 150 years, [HSBC] is pulling back from countries and businesses."

– A director

The impact of regulatory reform is increasingly hitting international bank models

A director said, *"Regulators may not intend to challenge global banking, but that is what is happening in practice. And that may be OK."* There are few truly "global" banks already, and even those that would fall into the category are retrenching: Citigroup announced in October its plan to shut down operations in an additional 11 countries after previous decisions to exit some markets.[19] Prior to the summit, one director observed, *"For the first time in 150 years, [HSBC] is pulling back from countries and businesses."* Since 2011, HSBC has withdrawn from 11 countries and sold 74 businesses.[20] Other banks that are jettisoning international operations include Barclays, RBS, and UBS, "reversing decades of global expansion."[21]

Some of these decisions result from simple economics: banks are struggling to make money in businesses or countries where they once saw big opportunities. Some participants see this as a logical shift that isn't actually a major departure from how international banking has always worked. They noted that outside of a few businesses, such as certain forms of investment banking, banking has never been a global business, but rather a *"multilocal"* one. But the changing cost structure brought on by calls for local capital, liquidity, systems, and governance could still make the shift from a local branch to a more self-sufficient subsidiary untenable for some banks, resulting in significant shifts in operations.

"This is much deeper than cost … It strikes at the whole modus operandi of a large, diversified, global bank."

– Director

A director asserted, *"This is much deeper than cost … It strikes at the whole modus operandi of a large, diversified, global bank."* For example, another director asked, *"How do you manage a global company if core management functions are cut off due to local subsidiarization?"* As the FSB was preparing to announce the agreed minimum total loss absorption capacity (TLAC) requirements for the world's largest banks, a participant said these requirements would challenge the justifications for combining businesses in a single group: *"Regulation is driving choices. TLAC is creating massive differences in capital absorption based on the size of the banks, and the capital you need* *to hold against things like small-business lending mean big banks may exit those businesses. So why keep those businesses within the same group?"*

Banks and regulators need to engage in a constructive policy debate about the role of international banks

A director noted, *"A debate about regulators' intentions is far too narrow – it is not banks on one side, regulators on the other. There are governments who fear the need to bail out a large bank domiciled in their country."* Participants broadly agreed that regulators and bank leaders can jointly inform and improve the policy discussions about the role of banking in the global economy. A director observed, *"Banks need to earn the right to grow, and regulators need to help ensure there is a constructive policy debate. We are aligned on the fundamental purpose of banking in the economy."*

Therefore, there may be a role for directors, who may be perceived as less self-interested than bank executives or industry associations, to work with regulators. A director said, *"Boards and regulators can influence policymakers together. There is some feeling of helplessness in some of these agendas if they become politicized. Safety and soundness need to be linked to sustainable profitability."*

"You still have global clients and everything else is becoming more globalized … But banks are asking whether they should be global banks in this regulatory environment."

– Regulator

Does the world need global banks?

If policy is still driving many bank decisions regarding their global structures and ambitions, then a fundamental question may need to be answered: does the world need global banks? At a BGLN discussion last year, a senior policymaker asked, *"Why do we need $2 trillion banks? I have yet to hear a concise justification from a CEO or anyone else."* In businesses like retail consumer banking and small-business lending, the answer is probably no. In others, customers may demand global, cross-border capabilities, for example, in cash management and trading. The case for globalization is less clear in other areas, such as hedging and risk management. Some observers have asked why a correspondent banking model, relying on global partnerships, couldn't serve multinational customers' needs.

In a discussion before the summit, an executive commented, *"If we put regulation to one side, are the rest of the drivers going in the direction of local or global banking? Cross-border commercial trade flows are one of the few remaining drivers of economic growth … Industries are more inclined to look to global trade for growth right now, and those industries need financial-services support on a global basis. That is a healthy driver of global banking."* At the summit, a regulator acknowledged, *"You still have global clients and everything else is becoming more globalized … But banks are asking whether they should be global banks in this regulatory environment."*

Are large, diversified international banks actually safer?

Most participants agreed that diversification decreases risk, suggesting simpler, smaller, more domestically focused banks may not actually be safer than larger, diversified international banks. A director asked, *"Has anyone really tried to model the question of what happens to risk levels as banks get bigger and more global? Does risk, at some point, go up or down? Do we know if banks are actually less risky being multilocal?"*

There is some evidence to suggest that they are: analysis of international bank models shows that banks that followed a decentralized, multinational model, matching assets and liabilities in each country, came through the crisis better than internationalized banks that employed centralized funds and often relied more on wholesale funding and foreign exchange swaps.[22] A director observed, however, that, *"banks are metastable – you can never have enough capital to fully mitigate the risks. Diversification of capital and businesses is another way to manage risk."*

What are the implications of changes to global banking?

Because limited analysis has been completed about how the reform agenda will impact global banking, and more broadly, what the implications will be for capital markets and economic growth, it is important that bank leaders and regulators engage policymakers along the way. A participant noted their shared objectives, saying, *"We have to accelerate and improve the dialogue among banks, regulators, and politicians, because economic growth, and the role of banks and impact on banking, needs to be a policy imperative as well."* Because of the low esteem with which banks are currently held by the public in many places, and concerns about the appearance of self-interested lobbying, a director noted, *"It is difficult for individual banks to engage alone in the policy debate."*

At a time when many commentators are talking about "lost decades" and debating the potential for "secular stagnation" – that is, long-term, structurally low growth in developed economies – the question of the role and importance of international banking takes on renewed urgency. As an article in *The Economist* noted in February, the economics of international banking – described as "raise funds in countries where they are cheap, lend where they are dear" – can be "both lucrative for bankers and good for the world, by channeling savings to their most productive use."[23]

International regulators are increasingly considering the impact of reforms. The FSB released a report in October saying it was "of the view that in order to better assess the implications of geographical separation requirements for cross-border financial stability, a clearer picture is needed of the range of national requirements for capital and liquidity held locally … The Basel Committee on Banking Supervision (BCBS) intends to take stock of jurisdictions' current and prospective treatment of cross-border branches and subsidiaries and report its findings to the FSB by end-2015."[24]

Important questions remain regarding how the regulatory reform agenda will interact with monetary policy and broader economic policy objectives. As a regulator observed, "*As soon as some regulations started biting, policymakers started asking, 'Are we doing the right thing?' There is now some recognition that we are not just changing the regulatory structure, but there are broader implications, including that it may affect the way we execute monetary policy."*

Will regulation continue to evolve?

At last year's summit, a regulator said that in the five years since the reform process began, *"we have made a lot of progress in putting in the broad regulatory framework. The overall shape is relatively clear."* [25] However, participants also noted that *"the impact on individual institutions is still very much to be determined."* [26] In addition, regulators suggested that the industry was only *"midway through the [prudential regulatory reform] journey,"* and that in some areas *"we have only just gotten to the most difficult questions."*[27]

"It was a political process that landed us where we are, not analysis about the optimal amount of capital."

– Director

A director at this year's summit suggested that banks could face continuously changing standards even as the formally agreed international reform agenda moves closer to completion: *"Is the present position on capital requirements for banks in stasis? There are arguments for banks to hold more capital, and they are quite sound. It was a political process that landed us where we are, not analysis about the optimal amount of capital."* A regulator said, *"Banks and investors sometimes complain about a lack of precise clarity, but it is just not realistic. Capital buffers will adjust in reaction to changing conditions, as the size of the bank changes, etcetera."*

Similarly, in past BGLN discussions, participants suggested it was time to "abandon all hope" of true global harmonization. Global standards set by the Basel Committee and the FSB are intended as minimum standards, not necessarily common standards (though they are focusing on ensuring consistent application). Before the summit, a participant said, *"Even if we all agree about Basel III, implementing it will require different things. Therefore, for banks with significant business in various countries, you cannot simply rely on your home regulator's interpretation of Basel III … [you must] understand the analysis and application in every country in which you operate."* At the summit, a regulator built on that line of thinking, saying that individual countries will continue to reserve the right to make changes: *"We all have our own rules, speak different languages, and that won't change. It is a cost of doing business internationally."*

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Financial Times columnist Martin Wolf recently wrote, "Cynics … may conclude that this manic rulemaking is designed to disguise the fact that the thrust of it all has been to preserve the system that existed before the crisis: it will still be global; it will continue to rely on the interaction of vast financial institutions with freewheeling capital markets; it will continue to be highly leveraged; and it will continue to rely for profitability on successfully managing huge maturity and risk mismatches."[28] Whether the system is changing fundamentally or not, a participant said that policymakers should now be asking a couple of basic questions: *"Are we now getting the system we want? Does it work?"* Another went further, advising, *"It is time to start defining what we want from banking, not just what risks we do not want. And that needs to take into account all stakeholders, not just taxpayers."*

"It is time to start defining what we want from banking, not just what risks we do not want."

– Participant

> *Globalization has reached a limit. The outcome of regulatory changes still remains uncertain. We need a greater focus on strategy now because of the phase of change we are in.* – Summit participant

As the industry moves further from the worst of the financial crisis, and as regulators approach completion of the principal elements of their reform agenda, bank boards are increasingly focused on developing a strategic vision for the sustainable future of their institutions. While many banks have already made significant strategic decisions in recent years, much of that focus has been on reducing exposures and exiting businesses and geographies.

Prior to the summit, a director described the persistent questions that limit strategic moves in the current environment: *"There are still some big-picture questions about where the world is headed, and there are practical challenges as to how we can plan for it. If we should expect a Volcker Rule 2.0 or if additional structural changes will be required because of resolution planning, or if continuing conduct issues cause politicians to feel forced to make more changes, it makes it difficult to plan."* Nonetheless, in a BGLN discussion last year, a bank leader stated, *"We need to see the world as it is, not as we would like it to be."*[29]

In a discussion in preparation for the summit, an executive noted, *"The top thing on most banks' agendas is getting returns up to an acceptable level."* Boosting returns may involve revisiting some fundamental questions related to customers, global expansion, and innovation. For many of the largest banks in the world, their home market is not growing, regulation is more restrictive, and scale may actually limit the ability to adapt to a digitizing world. At the same time, some hitherto regional banks, in Latin America and Asia for example, are developing international aspirations, increasing competition in some markets. Banks are now being much more strategic about where they expand and in what businesses they can compete in locations outside their core markets.

The summit discussion outlined not only the continuing challenges but also the opportunities that are emerging as banks consider new ways to serve customers globally.

Rethinking the benefits of being large and global

Limited economic growth in many large banks' home markets, the cost of compliance, regulatory constraints, and reduced risk appetites are leading all banks to be more selective about the portfolio of activities they pursue. That will inevitably mean retrenching from the less profitable ones, and for many banks, focusing on core strengths in fewer geographies. Yet it also raises questions about how banks can achieve the benefits of scale if they retrench. A summit participant said, *"There are three or four economies of scale or scope in international banking: (1) brand, (2) talent, (3) fungibility of capital and liquidity, and (4) governance systems. But the fungibility of capital is disappearing and the costs of complexity are offsetting the benefits of being global."*

International and business expansion is no longer a clear path to growth for two key reasons:

- **Identifying potential growth markets for expansion is not straightforward.** While many large banks' home markets face limited long-term economic growth, looking to emerging markets for growth is no panacea. A director summed up the difficulties: *"For financial institutions, pursuing growth in emerging markets presents compliance risks. The anti–money laundering campaign has become a barrier to operating in opaque economies, where there are real questions about sources of wealth … It is not just a commercial execution risk; it is a question of can you comply and make money. It is a high bar."* According to another director, *"Global used to mean that if you were a European bank, you were in the United States, often by buying a business there. Now, that opportunity is no longer growing, so how do you build a bridge into Asia? You can't just buy something in some Asian countries because regulators won't allow it, so global expansion is much more difficult."*
- **The benefit of having a broad scope of businesses is increasingly in question.** In response to the regulatory challenges to international bank models, banks are closely examining the costs and profits of operating different businesses in different places and asking whether they are still reaping the benefits of scale and diversification. As one participant noted, *"An investment bank is really just a conglomerate of different businesses that barely talk to each other."* Another said, *"Many banks don't look terribly profitable … So would it be so bad if some consider breaking up? In businesses like commercial and retail banking, there is limited reason to be global."*

"It is not just a commercial execution risk; it is a question of can you comply and make money. It is a high bar."

– Director

Because the cost-benefit ratio of diversified international banking is shifting, many banks are refocusing on core businesses in core markets. A participant counseled, *"Simplify, clarify, and focus only on those businesses where you have enough scale to achieve the benefits of that scale."* One director suggested that more banks consider the benefits of simplification: *"Having seen both a global, diversified business and a single-geography, single-line business, it is absolutely clear to me that you get much stronger, informed, tough, value-adding governance the simpler the business model."*

"Simplify, clarify, and focus only on those businesses where you have enough scale to achieve the benefits of that scale."

– Participant

Achieving sustainable profitability

A *Financial Times* columnist offered a harsh but uncommon critique of modern banking: "The business model of contemporary banking has been this: employ as much implicitly or explicitly guaranteed debt as possible; employ as little equity as one can; promise a high return on equity; link bonuses to the achievement of this return target in the short term; ensure that as few as possible of those rewards are clawed back in the event of catastrophe; and become rich. This was a wonderful model for banks. For everybody else, it was a disaster."[30] At a BGLN meeting last year, a participant stated, *"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."*[31]

If banks are going to achieve sustainable, profitable growth, they will need to change their thinking. A director observed, *"We need to grow well and sustainably, yet it is not obvious where growth will come from."*

Redefining growth and return objectives

Some would argue that an excessive focus on growth is precisely what led many banks on ill-conceived foreign adventures or into businesses they didn't fully understand. As a result, the way bank leaders are thinking about growth, given a *"bleak economic context"* in many markets, is changing. *"First, we have to define growth. Top-line growth will be hard … The main drivers of top-line growth in banking – economic activity and demand for credit – are primarily outside of the banks' control,"* one summit participant said. Another went further, stating, *"We don't need growth per se – we need profit, because profit creates capital."*

"We don't need growth per se – we need profit, because profit creates capital."

– Participant

A director noted, *"There was an important question raised in a BGLN discussion last year: are banks investable?"* The answer, according to another participant, is that *"to create shareholder value, we need profit above the cost of capital."* But how much profit above the cost of capital will be achievable over the longer term, and how much risk are banks willing and able to accept to get there? Different banks may reach very different conclusions. Regardless, participants suggested banks take the following steps:

- **Clearly communicating with investors.** Several participants questioned whether banks have done enough to reset market expectations about the sustainable returns they can or should deliver. Some participants suggested that as business models continue to evolve, banks need to be much clearer in communicating their growth and return expectations to the market. Those expectations could include lower but more stable returns, including less growth, but also a reduced risk profile. Such an approach might be more akin to state-owned banking models, but would a lower-risk, low-volatility but low-return "utility" model appeal to shareholders? One director suggested that it could: *"If the market has a zero return, why can't we accept that we are in a dip in the cycle? You can't get something the market can't deliver for you … We need to be clear about what we are aiming to do, what the return expectations should be, and stick by it."*
- **Redistributing returns.** While a significant portion of earnings go to meeting tougher capital requirements, a participant noted that in many wholesale banks, the bulk of returns above the cost of capital is still going to employees. Attracting investment given lower returns will require discipline in defining what share of returns will be retained for capital, what will go to employees, and what will go to shareholders.

"In all of the debate about regulation and changes to banking, one word has not been used: customer.

– Participant

Identifying targeted opportunities for international expansion

A summit participant observed, *"In all of the debate about regulation and changes to banking, one word has not been used: customer. Banking has become an incredibly introspective industry. We need to start talking to the customer."* The summit discussion highlighted different perspectives regarding the relative need for global banking services. One participant said, *"The number of clients that truly need a global bank is probably quite small – maybe 100 companies?"* But another suggested the need was much greater: *"The number of 'global' consumers is bigger than we think. Small companies moving into China are willing to pay a premium to go with a brand they know."* In a discussion before the summit, a director said, *"Big global customers do care, because we are creating inefficiencies, making life more difficult … but few corporates have global banking relationships. They want and are willing to pay for some inefficiency [to get] … a bank with a big balance sheet domiciled locally."*

So do customers need global banks? What international growth opportunities still exist? Participants identified two ways in which banks can grow cross-border services:

- **Develop a global proposition to serve local customers.** In some ways, a participant argued, the debate about whether customers *need* large international banks to serve them misses the point: *"Most companies serve local needs with a global brand or a global product. It means you have a proposition that you can offer local customers."* As banks improve their understanding of where and how they make money, they should focus not just on individual products but on understanding how individual customers are being served across products and services, how profitable those services are to the bank, and whether those services are core to customers' needs. Part of that process should involve being selective about which customers banks want to serve and identifying which needs of those customers they are best positioned to meet. As a secondary question, banks should look at where they can and should make the offer globally.
- **Selectively develop global offerings.** Despite a general trend toward shrinking international activities, participants insisted that offering some services to international clients can be effective. A director said, *"We can focus on what we are really good at, our core strengths, and take it on the road."* Another suggested that bank leaders ask, *"What can we do on a global basis? For capital and cost reasons, you should then scale back to focus on those areas where you believe you have a true competitive advantage and determine how best to grow in that area internationally."* Rather than *"be too small in a variety of places that have little to do with each other [or] try to invent some global product,"* one director emphasized the need to build complementary businesses in a few core markets. The director added, *"You need more than just booking centers to support clients in different markets."* Another participant argued that banks could also find new ways to serve clients internationally by offering services that may be outside of core banking activities but can nonetheless be provided across borders – for example, custodial services or offering a digital platform to franchises in other markets.

"Focus on those areas where you … have a true competitive advantage and determine how best to grow in that area internationally."

– Director

Refocusing on businesses with growth potential

Participants do see opportunities in the midst of the challenges and constraints. As one said, there are ways to improve returns on capital: *"One way you can do that is to reduce the amount of capital you are consuming. Basel III is encouraging different behaviors, including (1) a shift to less capital-intensive activities and (2) activities that do not consume capital at all."* Summit participants highlighted the following potential opportunities:

> *"There will be a clear role for banks as an intermediary or facilitator for a more mixed model for capital."*
>
> – Participant

- **Capital markets, especially in Europe.** A participant predicted, *"Banking will become less prevalent in credit intermediation as securitization becomes much bigger and the role of capital markets in Europe expands. There will be a clear role for banks as an intermediary or facilitator for a more mixed model for capital."*
- **Asset management.** Some banks have already expanded their asset management businesses, but a participant observed, *"Asset management has been difficult in banks because it requires a different mindset – that of a fiduciary. Then that raises the question, why have them in the same group? But it could represent an undertapped opportunity."* The Bank of England's Andrew Haldane recently described this as the Age of Asset Management because of the growth of asset managers globally.[32]
- **Payments.** The emergence of non-bank competitors leveraging technology to get into the payments business caused one participant to question why banks want to fight to own that business. But another participant said, *"The payments market will become very interesting. Banks are losing the battle very quickly, almost ceding the pitch. But it could be a growth opportunity."* According to another participant, the payments business currently represents a $350 billion-a-year business and it is projected to rise to $2 trillion in 2020.

Improving execution

The massive cost structures of most banks present opportunities not only for simple cutting, but for creating higher productivity and simultaneously improving customer service. Summit participants identified two areas of focus:

> *"Banks are losing the battle very quickly, almost ceding the pitch. But [payments] could be a growth opportunity."*
>
> – Participant

- **Upgrading customer service.** Banks need to understand what their customers want and how their experiences with other companies are impacting expectations. A participant described the vast differences in his experience obtaining a mortgage approval from two different banks as an example of how improving customer service can be a source of differentiation. Banks can identify opportunities to add value in different ways. For example, several participants noted that if banks could better assist international clients in establishing banking relationships outside of their home markets, many customers would be willing to pay a premium for their services.

- **Using technology to increase efficiency.** Banks will have to invest in major changes to their systems to improve customer interface, data analytics, and efficiency. A director said, *"The infrastructure in banks is far from the ideal you would create if you were starting fresh. Still, banks need to be as effective and as efficient as anyone else in providing service. That is how you can have a sustainable, if commoditized, business."*

Threats and opportunities of digitization

A participant declared, *"Digital does not equal growth."* The digital transformation of banking has garnered much attention, including in BGLN discussions.[33] It is an essential part of transforming the ways banks serve their customers and improve efficiency; however, participants were clear that investing in digital improvements was a competitive requirement, not necessarily the place to look for growth. While there are benefits and potential growth opportunities in investing in digital capabilities, the ability to offer banking services digitally has also given rise to new competitors, which one participant described as *"an absolutely crucial threat."*

Digital could, however, offer new ways of operating globally. While retail banking in particular has traditionally been a domestic business, technology and systems platforms are increasingly global. A participant noted, *"Amazon is a retail company that has used technology to become global. In a way, the same thing is happening in our sector."*

The threat of disintermediation

JPMorgan Chase Chairman and CEO Jamie Dimon described technology firms as one of the key competitive threats for banks: "When I go to Silicon Valley … they all want to eat our lunch. Every single one of them is going to try."[34] A participant noted, *"There are very innovative approaches being developed through the integration of finance into the economy"* – for example, peer-to-peer lending linked to the supply chain, which can replace banks in providing some services. Technology companies, unencumbered by the legacy issues and regulatory constraints facing banks, can move into financial activities more quickly and with far less expense. A participant observed, *"Digitization is stripping value out and giving it to the customer, which is fine, unless you are a bank with a cost structure from 1955 … Banks' costs are still high, while the costs of intermediation have collapsed."*

"Banks' costs are still high, while the costs of intermediation have collapsed."

– Participant

In addition, many firms are looking to get into things like payment processing less for the margins from those activities than for the information that comes with carrying them out. Prior to the summit, a subject matter expert predicted that while banks may get transaction revenue, *"the information is gone because someone sits in between banks and the customer."* This has prompted concerns about banks becoming disintermediated from their customers. *"Disintermediation is not a new problem,"* however, one director said. Instead, this director suggested, *"There are two ways we can think about it: (1) We have a massive infrastructure – it is like trying to heat a massive house built in 1750, getting something to perform like it's built for the modern era. That is not easy. (2) We can look at who is trying to eat our lunch and consider how to avoid that."*

The need for strategic investment

In 2013, banks spent an estimated $180 billion on information technology.[35] That may seem a massive sum, but participants nonetheless discussed the need for further investment in information technology to simultaneously improve multiple areas: efficiency, controls, data management, and customer service. If they are to make the kinds of investments and changes needed, some participants suggested banks may need forbearance from risk-averse regulators. A supervisor acknowledged, *"Where there are mutual benefits – controls, costs, efficiency – then regulators are likely to give more leeway."*

The summit discussion emphasized four ways banks can improve strategic investment in digital capabilities:

- **Rebuild core systems.** A participant asserted, *"Digitizing without decommissioning old systems is a recipe for chaos, yet that is where 95% of the players are now."* Some participants questioned why core systems couldn't support new technology. One said, *"Systems built 40 years ago are often still fit for purpose; they can be built upon."* But these legacy systems are often a blend of systems cobbled together over time and through mergers and acquisitions. The resulting cost of maintaining them is very high. As a result, some participants called for major transformational investment. One observed, *"The mistake banks often make is being incremental … You will need to do a significant rebuild."*

"Digitizing without decommissioning old systems is a recipe for chaos."

– Participant

- **Acquire capabilities.** Rather than build capabilities, some banks are buying them. For example, BBVA acquired Simple, a digital-only direct bank in 2014. The head of digital strategy at a bank wrote of the acquisition, "We'll likely see much more acquisitions of this type in the next few years. It's a smart move being repeated in other tech-industry verticals. Simple's acquisition also further proves that the coming contraction in the banking industry is not only real, but this reality should drive bank's primary strategy to focus in building scale and profit through digital."[36]
- **Invest in innovation centers.** Some banks are developing innovation centers outside the core bank to encourage development of new approaches. Some smaller banks are building a new digital bank alongside their legacy operations. Bank of New York Mellon recently announced that it was launching a technology lab in Silicon Valley, joining other financial institutions, including CapitalOne, Deutsche Banks, and Wells Fargo in doing so. Suresh Kumar, BNY Mellon's chief investment officer, said, "We're looking at the disruptions that are taking place in other industries – publishing, transportation, hospitality – and now you see a lot of disruption in the payment space and finance. We can't wait for someone to disrupt us and then react. We need to be in offensive mode here."[37]

"It is not just about digitizing processes; it is about how you think about a vertically disintegrated company."

– Participant

- **Develop new customer-centric business models.** Despite the threat from new competitors, digital does offer some opportunities for new approaches to operating globally. A participant said, *"It is not just about digitizing processes; it is about how you think about a vertically disintegrated company. Then, are there new business models where banks can play a role?"* As banks consider how they can leverage investment in digital capabilities, a participant said that they should focus on *"owning the customer's relationship with the financial system … The value is in the relationship. We should try to keep it from being disaggregated."* Instead, a participant claimed, *"Many banks are defending profitable business lines, but such that in the process they will lose it all, because they risk being displaced."* Another said banks need to think differently: *"In leading banks, technology is just as good as Google or Apple. It is more that they have a different mindset – they seek to attract people to them first. Give customers what they want, then you will find ways to make money."*

Can banks use digital investment to become innovative leaders in the digital space, the financial services analogies to Apple and Google? Participants did not say that this was impossible, but they generally agreed with one who said, simply, *"It is very hard."*

Securing the right people to lead the transformation

As banks consider changes to their business models, some directors are concerned about the ability to attract and retain the management to lead their banks through a difficult transition and into the future. A participant illustrated the challenge: *"We are still among the best-paying industries, yet it is hard to attract talent."* Regaining the trust and esteem of society remains a central challenge for banks, particularly if they hope to attract the best and brightest. Even those attracted to finance may seek careers elsewhere.

Some participants also wondered how they could make commitment to a bank an attractive career decision rather than a stepping-stone – *"a five-year project"* – before moving on. They worry that some of their best people will use banking experience as a training ground to move to private equity, asset management, hedge funds, or other corners of the shadow banking world.

"If I were a young person, I would go into shadow banking."

– Participant

Prior to the summit, a participant shared a comment from a bank executive who said, *"If JP Morgan came back today, and he was given the option of taking Jamie Dimon's seat, or [Blackstone Group chairman] Steve Schwarzman's, whose do you think he would take? I think he would almost certainly take Steve Schwarzman's, and not just because he makes a lot of money."* At the summit, a participant said, *"If I were a young person, I would go into shadow banking. There is a sense of opportunity and excitement there and regulation continues to push more activities there."*

Current employees have also been under pressure for years now, primarily addressing risk and compliance issues and reacting to regulation. Several directors expressed concern about the volume of ongoing change in banks, with the range of regulations, investments in technology and infrastructure, and exiting and divesting from some businesses and locations. Many of these activities are being driven by the same group of people within the bank. A director observed, *"There is an issue of the overload of change and the problem of execution, given multiple things coming from different countries, all coming down the pipe at the same time."*

BGLN participants suggested that banks may need to rethink the talent and resources they need to lead a transformation from an old-fashioned bricks-and-mortar bank to a modern, digital concept, from senior management down through the organization. One participant said, *"It is as much about managing the strategic mindset of the people currently in the bank as it is about attracting new people."* Most bank executives and directors have grown up in banking and know the business as it has been, but not necessarily as it needs to be to compete in the future, nor are they always equipped to lead the kind of transformation that may be required.

"If you can paint a picture of the future, you can get people excited about working in banking again."

– Director

As regulation and derisking stabilize, and banks are increasingly able to articulate their value proposition to society and to individuals, the opportunities within banking should become more attractive again. A director commented, *"The ability to make the digital transition seems contingent on [banks'] ability to attract people."* Strategic transformations, like the shift to digital, can be the source of opportunities for young, creative, entrepreneurial employees: *"You need a local team to develop customer apps in each country; you need to source the right people in the right places. And that can present attractive opportunities in banks,"* according to one director.

Ultimately, banks need strong leadership and a clear vision of what is possible. As one director said, *"If you can paint a picture of the future, you can get people excited about working in banking again."*

★★★

One director observed, *"Most of the businesses created during deregulation are being killed by regulation. Maybe they should never have existed?"* If that is true, then finding growth and profit will require new thinking about what needs customers have now, and what products and services banks are best positioned to offer in response. And increasingly important is where and how they will choose to offer them given the changing costs and risks of international banking. One participant advised, *"We need to avoid the mindsets of 'It worked last time,' or 'Good enough is good enough,' or 'We are doomed to become a utility,' or 'The world will come around and we will be alright.'"* Thus, a director said, *"It is time for really focused, forward-looking leadership … It is time to take those really difficult decisions."*

> If those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist … The inevitable conclusion will be reached that your firms are too big and complex to manage effectively.
> – William Dudley, President, Federal Reserve Bank of New York[38]

The challenges of governance in large banks have been central to the BGLN agenda since the network began in 2009. These challenges have only increased since then. Bank boards have been spending more time and have added new people to address criticisms leveled by the media, investor groups, and by government authorities. At last year's summit, participants agreed that bank directors face permanently elevated expectations, which require them to devote significantly more time to the role than was typical before the crisis.[39]

Despite banks' efforts to improve governance – both through their own initiatives and those undertaken in response to new regulations – commentators continue to question their effectiveness. Boards face continued scrutiny given the role of large banks in the economy and the heightened risk of failure. Conduct and compliance issues continue to emerge, even in banks that have reputations for being well managed and well governed. Analysts and regulators have renewed questions about the governability of the largest, most international, and most complex banks.

"Boards have an ever-increasing standard of care … So, you need to act accordingly."

– Participant

At the 2014 summit, participants discussed the continuing evolution of expectations and objectives for bank boards. One participant summarized, *"Boards have an ever-increasing standard of care. That is the way it is. So, you need to act accordingly."* But banks need greater clarity regarding standards, roles, and responsibilities as banks face a new challenge: attracting directors who are qualified to take on the role and who have the stamina and personal risk appetite for the job.

Regulators are renewing their focus on governance in large banks

In his letter to the G20 leaders ahead of the Brisbane summit in November, FSB Chairman Mark Carney reported that "the job of agreeing measures to fix the fault lines that caused the crisis is now substantially complete," noting, "The industry too must play a role and improve its own culture, ethics and governance."[40] Andrew Bailey emphasized the importance regulators are placing on governance in completing the reform agenda: "Whilst more capital and liquidity was a necessary condition for fixing the financial system, it wasn't sufficient. Getting the incentives and governance right matters a lot."[41]

Some have suggested that sweeping reforms targeting governance may be necessary. In June 2014 Federal Reserve Board Governor Daniel Tarullo said, "The interests of shareholders and the public overlap, they are not coincident," and asked, "How, then, might corporate governance be changed to incorporate risk considerations consistent with micro- and macroprudential regulatory objectives? One way would be to broaden the fiduciary duties of boards and management."[42] Others have called for expanding staff support for boards, requiring directors to work full time, or in the extreme, asking whether board duties might be outsourced to professional-services companies.[43]

Summit participants generally agreed that boards of non-executive directors can be effective in well-defined roles and that effectiveness depends to a large extent on having the right mix of perspectives and expertise, and directors who have the time and willingness to engage and challenge. Though governance structures vary, as do participants' experiences with those structures, they are rarely the determinant of effectiveness: a participant observed, *"There are plenty of high-performing one- and two-tiered boards and plenty of low-performing one- and two-tiered boards."*

A participant said, *"Governance really is about sound risk management."* And yet, even with the additional time directors are spending on risk appetite and improving risk reporting, cases of misconduct continue to emerge, leading regulators to question what this says about the quality of risk management and governance more broadly. A director suggested these issues represent *"a failure to self-regulate."* Participants raised three core questions. First, do bank boards truly understand the risks to their institutions better now than they did before the crisis? Second, is it really possible for part-time non-executives to ever fully understand and oversee those risks in a large, complex, international bank? Third, will the emphasis on risk and compliance inevitably crowd out a board's critical responsibility for overseeing strategy? The *"bigger and broader"* a bank becomes, the tougher it is for the board to satisfy itself that it has understood the risks and that they are well controlled. Operational and conduct risks pose particular challenges. Nevertheless, one director was confident that good governance is *"perfectly doable regardless of the size of the institution."*

"We need clarity, otherwise the governance system is just getting bigger and more complex."

– Director

Sharper individual accountability requires clarity regarding roles

A director stated, *"Clarity regarding roles, responsibilities, and accountability is truly important. We need clarity, otherwise the governance system is just getting bigger and more complex."* Pressure for boards to delve deeper into the details of the business, to understand risks, culture, and to monitor behaviors continues to elicit concern about the expectations being placed on non-executives and about crossing the bright line between management and the board. There is a growing sense that boards are increasingly accountable to regulators: A London School of Economics researcher recently surveyed bank risk committee chairs asking them to whom they were accountable. While many answered "the full board," or "shareholders," a majority added "regulators." A director said, *"There is an interesting challenge for boards between the regulatory requirements, for example coming from the regulatory standards, and the actual dynamics of the board: can you square the circle?"*

Risk and regulation continue to drive board agendas

At the summit, participants discussed the need for bank leaders to develop a forward-looking strategic vision for their institutions, and participants called for boards to spend more time on strategic issues. Yet, some participants said their boards are still spending as much as 80% of their time on regulatory issues and implications, more than they do on major business model challenges like digitization. A supervisor said, *"If the board is spending 80% of their time on risk and regulatory issues, I am worried as a regulator."* But several participants stressed the importance of regulatory change: *"Regulation is the biggest driver of business model change in banking. What is coming from regulation is now strategic,"* said one. Another commented on the importance of regulation to strategic discussions, saying, *"Strategy of a regulated entity is an art form … All governments and regulators are doing what they think is best for their country, but there is no doubt there is arbitrage as a result. That has to be taken into account in setting strategy. That is a critical element of management and the board's job."*

"There is the risk of the board job becoming undoable."

– Director

Precisely what boards should be held accountable for remains an open question

Regulators are emphasizing individual accountability for behavior and for avoiding failure, and they are extending that accountability to non-executive directors. The new senior-managers regime in the United Kingdom, for example, will apply to non-executives who are chairs of a major board committee, chair of the board overall, or the senior independent director.[44] A director suggested the renewed focus on accountability should lead to greater discussion of the level of detail that boards are expected to understand, but different stakeholders, and different regulators, are expecting different degrees of depth of engagement and understanding from the board.

A summit participant offered the following guidelines: *"The board should be accountable for (1) acting as fiduciary, (2) people – oversight of management and ensuring we have the right people, (3) policy decisions at the proposition of management, as opposed to the proposition of the board."* Acting as fiduciary, which entails overseeing strategy, is a massive task in and of itself. A director said, *"The sustainability of the business model – that is tough stuff. It is quite difficult to see how I could really do the job with less than a significant portion of my time."* Another said, *"There is the risk of the board job becoming undoable. There is a creeping trend toward giving the board more direct accountability … You could end up with full-time, professional non-executive directors, but at that point, I am not sure they are non-executive anymore."*

Conduct and compliance issues raise questions about the appropriate level of detail

As conduct issues have come to the fore, and operational risk rises to the level of strategic risk, it is causing boards to reconsider what level of oversight is required. In a discussion after the summit, a director suggested expectations on boards may be reaching unachievable levels: *"If we look at operational risk, for example, it is extremely hard to govern the behavior of individuals across an entire organization."* While some participants questioned whether boards can truly oversee conduct issues at the individual employee or even at the product level, another observed, *"There are conduct issues and there are conduct issues. If conduct risk becomes a strategic threat, that gets close to risk culture, which we agreed is the responsibility of the board."*

"It is extremely hard to govern the behavior of individuals across an entire organization."

– Director

Regulatory guidance and expectations contribute to ambiguity

In past BGLN discussions about governance effectiveness, participants noted the importance of rigorously defining the words used when describing the role of boards, particularly in regulatory guidance. For example what do regulators mean when they ask the board to "approve" something? What does the board mean when it says it has "reviewed" something? These questions take on even greater weight in the context of these questions about individual and collective board accountability. For example, to refer back to the discussion on recovery and resolution planning earlier in this *ViewPoints,* are boards expected to have carefully read 3,000 page plans? Or should they, as most participants suggested, focus on the key assumptions and decisions included in the plans?

A supervisor accepted some responsibility for the lack of clarity directors face, noting, *"Supervisors struggle with this a lot. There is so much being put on boards … If we make everything a priority, then nothing is."*

Misconduct has intensified the board focus on culture

Recurring misconduct issues in banking have been characterized as an issue of culture, to be addressed by individual institutions, but also permeating the industry. Several commentators have said that misconduct extends beyond "a few bad apples," and regulators have called for "collaborative solutions aimed at improving culture and rebuilding the public trust."[45] According to an *Economist* article from November 2014, "Regulators are particularly angered by the currency scandal because it came to light soon after banks were found to have tampered with LIBOR … Banks paid fines (some are still negotiating them) and promised a change of culture they have failed to deliver."[46]

"What we need is a culture that says, 'Here is what happened, here is what we are doing to manage it, and here is what we are doing to correct it.'"

– Director

Summit participants acknowledged that there may be cultural issues that require additional attention. One director said, *"The culture of the industry has traditionally been one where people felt they needed to explain away any failings, to say, 'Here is why this isn't a big deal.' What we need is a culture that says, 'Here is what happened, here is what we are doing to manage it, and here is what we are doing to correct it.'"* Another said, *"It is not unlike other industries in some respects. You can ensure you develop a culture of rigor around execution."*

Referencing Pope Francis's remark that priests should be "shepherds living with the smell of the sheep,"[47] a participant wondered how, burdened with increasing board responsibilities, directors can *"get the smell of the sheep in [their] nose?"* In other words, how can non-executives stay close enough to what is happening lower in the organization to understand and influence culture? A director stated, *"One of the most important things I do is stay in regular touch with all of senior management."* BGLN discussions have addressed culture before, but the attention from regulators and policymakers, continuing conduct issues, and the heightened risk of getting it wrong prompted many summit participants to say culture is one of the most important issues for further discussion and engagement going forward.

Subsidiary boards are becoming increasingly important

Regulators are increasingly insisting that international banks maintain empowered subsidiary boards, often with independent directors. The group boards of these banks are this trying to define the responsibilities and decision rights of their subsidiary boards.

Apart from regulatory pressures, scale, complexity, and concerns about compliance risk are leading some boards to rely on subsidiaries for management of local operational issues. Prior to the summit a director observed, *"There is no question that a group board can operate at the level of portfolio decisions – for example, determining whether to invest capital in this business or reduce capital in another. That is fine, and boards can add a lot of value. But when it comes to things like are you treating your customers fairly and understanding the customers' perspectives, technology risk, etc., it is impossible for a board of 10 part-time, non-executive directors to have the level of insight required."*

One solution is to give subsidiary boards more responsibility for oversight of local entities – an approach some regulators are already driving. A summit participant stated, *"You want separate governance where you have different regulation and capital requirements."* Yet a director cautioned, *"There is a big cost to a local subsidiary model, but that is just one we have to bear. What I am more concerned about is blurring the lines of responsibility."* Participants considered the following aspects of responsibility:

"When everything goes well, it works fine, but if there is a multibillion-dollar loss somewhere, who is on the hook?"

– Participant

- **Who is ultimately accountable for local operations?** If subsidiary boards are being empowered, who then is accountable for performance of local businesses? Subsidiary boards can be helpful in compliance with local regulations and local norms. For example, in some banks, compensation decisions in a given market are reviewed first by the subsidiary board before going to the group board. Even at the local level, however, a participant cautioned, *"It is still impossible to have real insight at the product level. You need management committees. Otherwise, this can contribute to the infringement on management responsibilities."*

  Equally important, who is responsible for a subsidiary's failure or misstep, the group board or the subsidiary board? A participant asked, *"When everything goes well, it works fine, but if there is a multibillion-dollar loss somewhere, who is on the hook?"*

- **How should responsibilities be divided?** A director described the relationship and roles of the group and subsidiary board thus: *"The overall direction of travel needs to be clearly defined at the group level. Local boards are part of the overall execution of board governance, but they are subordinate."* Strategy needs to be set by the group board, with the subsidiary responsible for execution of that strategy locally: *"The group board gives the subsidiary board an objective, then the subsidiary develops the appropriate business model to achieve that."* But this can also be complicated. Another director said, *"Left alone, I am* *not sure we would have concluded that we needed non-executive directors for the subsidiaries. It is difficult in an investment bank in particular, because strategy is typically set globally."*

- **How do group and subsidiary boards align activities and stay mutually informed?** Participants suggested cooperation between the group board and its subsidiary boards remains a work in progress. One asked, *"Often, there may be a particularly large subsidiary: does the risk committee of the group review the work of that subsidiary's risk committee?"* Some boards hold quarterly meetings for group and subsidiary committees to meet and review each other's reports. There are also things subsidiary boards are positioned to do – for example, assessment of internal audit in the subsidiary – that the group board can leverage in their groupwide reviews.

Will boards be able to find directors equal to the task of serving?

The need for qualified directors with an expanding mix of skills and experience is clear. What will attract those people to join bank boards is less clear. Participants discussed balancing banking and other relevant skills, the challenge of navigating supervisory reviews, the time requirements of a bank director, and the risks associated with being a bank director in the current environment.

What skills and experiences are desirable?

Many regulators have increased the rigor of their assessments of the qualifications of individuals selected to join bank boards. Effective boards are greater than the sum of their parts, and good boards have directors with diverse experiences and expertise. Summit participants discussed some of the challenges in achieving the right balance:

"Not everyone needs a deep understanding of hedging."

– Director

- **A broad set of perspectives.** As banks transform their business models, experience from other industries that have undergone their own digital transformation, such as retail consumer goods, or from industries with useful approaches to risk management, such as energy companies, are extremely valuable. A director said, *"Someone who understands how we can transform our institutions, even if they don't know a lot about banking, can be extremely valuable and a breath of fresh air."* This director reported, *"We added a young tech entrepreneur, and he brought great challenge and a more forward-thinking view on strategy and digital issues that are fundamental to the industry."*

- **Banking expertise.** Directors from outside the banking industry are important because, as one director noted, *"If there are too many bankers, they can become like sheep following each other, and not necessarily in the right direction."* And while financial services expertise is valuable, *"not everyone needs a deep understanding of hedging,"* according to one director. At the same time, banking and other financial services experience remains extremely important if boards are to understand the complexities of modern banking, which can be baffling to the uninitiated. A director said, *"I try to imagine friends who have had very successful careers in industry trying to understand what is going on in our board conversations."* Unfortunately, *"experienced bankers with untarnished reputations are in short supply."*

Although there is a risk that directors with financial services experience will become *"more equal than others,"* as chairmen and key committee chairs in particular take on responsibility for delving deeper into the details, some participants are happy to entrust that responsibility to those with expertise. A director said, *"I get some comfort knowing the chairman is full-time, engaged, knows the bank, and knows the market."*

- **Current executives.** Given the time commitment required, getting current executives onto bank boards can be difficult. Some of those who have taken on the role say finding time to prepare for and attend formal board and committee meetings – totaling 12 – 15 times per year – is very challenging. However, many are used to balancing multiple priorities and making efficient use of time (they may, for example, use travel time to do their board reading, etc.). One said, *"We are 24/7 people."* Their current experience in other industries can be relevant to the job of a director: according to one director, *"My profession helps me understand the issues in banking that I am dealing with from a board perspective."* Typically, however, they have less available time than retired professionals, and expectations for their contributions may be adjusted accordingly. Few would be able to serve as an audit or risk committee chair, for example.

What is the time commitment needed?

As expectations of boards have expanded, directors have increased the time they devote to the role. There are limitations on how much time non-executive directors can devote to what is intended to be a part-time role, however. Given that the demands placed on the board are unlikely to abate, the implications for recruitment are important.

"I spend more time [at the bank] than anywhere else."

– Director

While specifics vary with jurisdictions and institutions, the minimum time requirement for non-executive directors remains high across all large banks. Participants reported an absolute minimum of 25 – 30 days (which some regulators see as insufficient) and at the other end of the spectrum, more than 60 days a year – a commitment of at least 25% of their time. Some participants, particularly non-executive board and committee chairs, said the time devoted to their roles was closer to 100 days or more a year. One director said simply, *"I spend more time [at the bank] than anywhere else."* And one director cautioned, *"It is an illusion to think that even at 100 days per year a non-executive can efficiently exercise control of the range of issues in a bank across thousands of people."* As a result, a director insisted, *"How we spend our time is within our control."* Another said, *"The chair of the board needs to manage how the time is spent and ensure there is sufficient time on the past, present, and future. The balance shifts, but you need to find a way to do it all."*

Who wants to be a bank director?

Some participants expressed concern that bank boards will have trouble attracting the kind of people they need if expectations and risks for directors continue to increase. They are not alone in this assessment. Outgoing RBS Chairman Philip Hampton said, "This does bring a risk of diluting the quality of boards. We all know bank boards have to improve, but it's a fairly small pool of people who are qualified for the role, ready for the greater time commitment of a bank board, and also the extra personal exposures."[48] And Andrew Bailey reportedly acknowledged at a conference that prospective bank directors might ask, "Why would I want to do this?"[49]

While the role has been particularly challenging since the financial crisis, the demands of key board roles have only increased. At the same time, personal reputational and even legal risk is growing. As more banks build subsidiary boards, the demand for non-executive directors is growing as the ability to attract the best people is becoming more difficult. A director said, *"Even 18 months ago, I would not have said this, but it is now becoming remarkably difficult to find people to take on the main committee chair roles because of concerns about personal liability, the level of questioning from regulators, and the time commitment required."* Another summarized, *"The reward really isn't there, while the risk is clear and present."*

"The reward really isn't there, while the risk is clear and present."

– Director

The reputational risk is a particular concern. A director noted that even *"modest errors of judgment could see your whole reputation sullied,"* and another said, *"It is a scary business to be writing options on your reputation."*

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If good governance is ultimately about sound risk management, then boards and individual directors are still wrestling with the best way to oversee the diverse risks in international banks. And those risks are also increasingly personal. A director remarked, *"You only really enter into it if you believe you can get comfortable with the level of risk."* And fewer and fewer are able to do that. One director concluded, *"Would I join the board, the risk committee of a big, global bank with an investment bank, now? No."*

About the Bank Governance Leadership Network (BGLN)

The BGLN addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy banking institutions. The BGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the BGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients and for its communities. EY supports the BGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix: Summit Participants

Over the last year, Tapestry and EY hosted six BGLN meetings, including the sixth Bank Directors Summit, and had nearly 150 conversations with directors, executives, regulators, supervisors, policymakers, and other thought leaders. Insights from these discussions helped to shape the summit agenda and inform the enclosed *ViewPoints* documents.

The following individuals attended the 2014 Bank Directors Summit:

Directors

- Lord Norman Blackwell, Chairman, Nomination and Governance Committee Chair, Remuneration Committee Member, Risk Committee Member, Lloyds Banking Group
- David Cannon, Non-Executive Director, Audit Committee Chair, Morgan Stanley International
- Sir Sandy Crombie, Non-Executive Director, Group Performance and Remuneration Committee Chair, Audit Committee Member, Group Nomination Committee Member, RBS Capital Resolution Board Oversight Committee Member, RBS
- Axel Lehmann, Non-Executive Director, Risk Committee Member, UBS
- Sir Callum McCarthy, Non-Executive Director, Strategy Committee Vice Chair, Risk Management Committee, Nomination Committee, ICBC
- Nathalie Rachou, Non-Executive Director, Audit, Internal Control and Risk Committee Member, Société Générale
- Sarah Russell, Non-Executive Director, Audit Committee Member, Nordea
- Diane de Saint Victor, Non-Executive Director, Audit Committee Member, Conduct, Operational, and Reputational Risk Committee Member, Barclays
- Kathleen Taylor, Chair, Human Resources Committee Member, RBC
- John Tiner, Audit Committee Chair, Chairman and Governance Committee Member, Risk Committee Member, Credit Suisse
- Anton van Rossum, Non-Executive Director, Risk Committee Member, Credit Suisse

Executives

- Roberto Nicastro, Group General Manager, UniCredit
- Bill Winters, Chief Executive Officer, Renshaw Bay

Regulators and Supervisors

- Martha Cummings, Senior Vice President, Complex Financial Institutions, Financial Institution Supervision, Federal Reserve Bank of New York

Regulators and Supervisors *cont.*

- Michael D'Souza, Senior Advisor, Prudential Regulation Authority
- Bertrand Peyret, Director, Supervision of General and Specialized Credit Institutions, French Prudential Supervision Authority
- Michael Schoch, Head of Banks Division, Swiss Financial Market Supervisory Authority FINMA

EY

- Ian Baggs, Global Banking & Capital Markets, Deputy Leader, Financial Services
- Andy Baldwin, EMEIA FSO Regional Managing Partner
- Hugh Harper, EMEIA FSO Strategy, Customer, and Operations Leader
- Ted Price, Advisor, Risk Governance
- Isabelle Santenac, EMEIA FSO Assurance Managing Partner

Tapestry Networks

- Dennis Andrade, Principal
- Leah Daly, Principal
- Jonathan Day, Vice Chairman
- Peter Fisher, Partner

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