Executive summary

- A lack of robust corporate governance processes combined with a lack of Board commitment to developing and overseeing risk management systems have been recognised as contributing factors in the financial crisis.

- The Board must ensure that a comprehensive risk management process is put in place with specified parameters of the firm’s risk appetite and tolerance, and it must oversee the operation of the firm’s risk control processes and culture throughout the firm. It is irrevocably a Board’s responsibility to satisfy its supervisors, and ultimately its shareholders, that appropriate Board governance and risk management policies are in place.

- There is no single governance model that will be appropriate to all firms in all jurisdictions. The Board must determine the appropriate governance measures for a firm after considering its business model and legal/geographical structure.

- There is a need for a coordinated global approach to corporate governance by supervisors to ensure that the differences between global firms and regional/national firms are efficiently recognised in regulation.

- One way to ensure the whole firm is aware of and actively seeking to minimise systemic risk is to link remuneration to compliance and risk management objectives.

Sound corporate governance practices are the key to effective risk management. Hence it is no surprise that this aspect of financial institutions’ management has come under considerable scrutiny since the crisis. It does appear that, in the recent past, the Boards of some banks showed a lack of commitment to the important responsibility of setting risk tolerances or appetites. In some cases, they have failed to ensure the establishment of independent and competent risk management structures and processes capable of identifying, measuring and controlling risks, or to oversee results.

The parameters of a firm’s risk appetite and tolerance must be established with the consent of the whole Board. The process by which the risks that fall within the scope of those parameters are independently identified, assessed, and controlled may be delegated, provided that there is sufficient independence from business leadership to allow appropriate challenge.

An important point to note here is that delegation does not permit abrogation of responsibility. Boards must charge themselves with the ultimate responsibility to ensure that its own culture encourages independent challenge on risk issues.

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AFME has considered and responded to the consultations issued by Sir David Walker and the Financial Services Authority (FSA); the proposals from The Basel Committee on Banking Supervision (BCBS) and, more recently, the EU Green Paper on Corporate Governance. All of these responses are available on our website (www.afme.eu).
understand the important risk aspects of all of the firm’s businesses and ensure that the firm has the personnel and technical resources in place to manage risk appropriately. The Board must ensure that its own culture encourages independent challenge on risk issues, which is not susceptible to being overreached at Board level by very strong business leadership.

In this respect a Board should institutionalise its culture of independence through its own governance structure, processes and selection of directors. It must be capable of overseeing the enterprise as a whole, through oversight of the proposals and actions of senior executive management.

We note that there are numerous possible approaches to establishing an effective risk management process. One option is that the Board establish a Board-level Risk Committee, chaired by an independent director, to perform the risk function and advise the Board. Another is that a firm appoints a Chief Risk Officer (CRO) with access and accountability to the Board’s Risk Committee and the full Board. This person would be empowered to assess financial risk issues independently of the executive team and to oversee the risk management structure throughout the enterprise. Both approaches are sound but they are not the only creditable options and may not be appropriate for some financial firms.

We do not believe that any specific model should be mandated for all financial firms because one model cannot be appropriate for every firm. The implementation of governance principles should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs. These differences may require different approaches, which could include:

- oversight by the board;
- oversight by senior management;
- direct line supervision of different business areas;
- independent risk management, compliance and audit functions; or
- any combination of these approaches.

Since there are so many important variables it would be a difficult task to set out a comprehensive governance path for international finance groups, or to define an appropriate governance methodology between a parent company and its subsidiaries. No one paradigm would fit all international groups or all parent-subsidiary structures. We advocate that each Board should continue to have the responsibility to determine what governance measures are appropriate for a firm after considering its business model and legal/geographical structure. Some particular points to bear in mind are:

- the extent to which governance principles should be implemented by a particular subsidiary should be for the Board of that entity to decide, subject to review by its supervisor;
- since subsidiaries typically will benefit from the corporate governance structures applied at the parent level and the oversight of group employees, there should be no presumption or requirement that a subsidiary should replicate exactly the same structure as its parent;
- the benefits of ensuring harmonised standards, and achieving a global view of risks, point to the use of firm-wide committees (with appropriate regional and entity representation) rather than establishing equivalent committees for each relevant entity;
- there may be cases, however, where it will make sense to have entity specific committees operating in coordination with equivalent firm-wide committees. For example, banks with firm-wide audit or risk committees may also choose to establish one or more entity-specific committees to ensure detailed focus on the specific risks carried in the group’s major subsidiaries; and
- generally, there is a reduced need to have non-executive directors or independent members on the boards of subsidiaries or on their committees.
Global Regulatory Framework

More generally, we endorse the view of the Basel Committee on Banking Supervision that there is no need to establish a new regulatory framework to be layered on top of existing national legislation, regulation or codes. As long as several essential functions are in place, sound governance can be achieved regardless of the form used by a banking organisation.

Crucially, it will be necessary for the bank regulators in each country to carry forward this perspective when implementing principles and policies within the context of their local legal and regulatory frameworks. In our view it is critical that a prescriptive regime not be promulgated by supervisors or governments. In a unitary Board, the Board is responsible as a whole and must determine how to govern itself and the optimal method of managing and controlling risk.

The Role of Senior Executive Management

Generally, the executive role of senior management must be distinguished from the oversight role of the Board when:

- setting and enforcing lines of responsibility and accountability throughout the organisation;
- ensuring the regular review of policies, processes and the control functions; and
- differentiating the Board’s responsibility to ensure that the control functions are set up to operate independently and efficiently.

The Board should satisfy itself through its dealings with senior management (and others if deemed necessary) that the control functions, policies and procedures of the firm are robust, appropriate and proportionate.

Remuneration Policy

In the immediate aftermath of the financial crisis, AFME members acknowledged that more needed to be done to align incentives with proper risk management and worked to design remuneration structures that complement the control and risk management functions. Even before the G-20 endorsed the FSB Principles and the related Implementation Standards, AFME members had already implemented – and frequently exceeded – the core provisions. A comprehensive description of the changes that have taken place is beyond the scope of this paper, but includes:

- allocation of remuneration between fixed and variable pay has been re-examined and recalibrated;
- the amount of variable pay is now determined by reference to a broader range of metrics (including compliance and risk adjustment) assessed over a longer period;
- a larger proportion of variable remuneration is now paid in equity;
- variable pay is now deferred to reflect the long-term risk profile of the individual business unit and institutions;
- guaranteed bonuses are offered only in exceptional circumstances; and
- variable compensation can now be clawed back for underperformance or malfeasance.

Even as the structure of remuneration changes (and the absolute amount reduces), it is vital to recognise that the financial services industry operates in a global and competitive environment so international coordination is critical. Banks rely on human capital to put financial capital to work productively and efficiently. Talent is limited and competition fierce. Only an appropriate degree of flexibility will ensure that the labour market functions properly.

Equally important is that ultimate responsibility for the structure and oversight of remuneration be vested unambiguously with the Board (assuming that the enhanced governance safeguards and remuneration policies discussed in this chapter are in place). Shareholders have a valuable role to play in signalling their views directly on particular matters, but only directors can closely coordinate the alignment of remuneration policies with the overall risk profile and strategic direction of an individual firm.
Directors’ Responsibilities/ Liabilities

It has been suggested that the potential liabilities of directors in general, or of non-executive directors in particular, be increased. We consider that such a move would be counterproductive and unfair. Parent bank Boards are generally oversight bodies that are not charged with managing the daily activities of the company. Corporate governance codes should reflect this oversight role. For example, in a complex financial institution, there will be many subsidiaries and it is impractical for a Board to have extensive awareness of the details of individual entities. Applicable laws and regulations should explicitly recognise the concepts of materiality and reasonableness, policy review, and the ability to delegate when dealing with Boards’ and directors’ responsibilities. Nevertheless, it is irrevocably the Board’s responsibility to satisfy its supervisors, and ultimately its shareholders, that appropriate Board governance and risk management policies are in place.

This paper does not specifically address the relationship between a Board and its shareholders, although we do believe that the chair of the Board risk committee (or its equivalent) should be available to take questions at the AGM and a report from the committee should be filed with the annual return. Shareholder involvement with financial institutions is, in practice, a mechanism for limited control of risk management. The relationship with supervisors is, on the other hand, central to this function and is considered in the next chapter.

Further reading:

OECD Principles of Corporate Governance (as revised 2004)  

Sir David Walker: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities  

Basel Committee on Banking Supervision: Principles for Enhancing Corporate Governance (Consultative Document)  
http://www.bis.org/publ/bcbs168.pdf

EU Commission: Green Paper on Corporate Governance in Financial Institutions and Remuneration  

http://www.cfr.org/project/1404/squam_lake_working_group_on_financial_regulation.html

IIF (in Cooperation with Oliver Wyman, Compensation Reform in Wholesale Banking 2010: Progress in Implementing Global Standards (September 3, 2010)  

Significant regulatory initiatives:

CRD III provisions relating to remuneration, parliamentary press release:  

FSA CP 10/19 Revising the Remuneration Code (proposals to implement CRD III in the UK):  

EU Green Paper on Corporate Governance:  

FSA/FRC DP 10/3 Enhancing the Auditor’s Contribution to Prudential Regulation:  
http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf

FSA CP 10/3 Effective Corporate Governance (Significant Influence Functions and the Walker Review):  
http://www.fsa.gov.uk/pubs/cp/cp10_03.pdf