

# Corporate Governance

*Players – Rules - Gameplay*

*Author: Bernhard Spalt, CRO*

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# Corporate governance introduction. The Gameplay

## Corporate governance

*“A set of relationships between a company’s management, its board, its shareholders and other stakeholders which provides:*

- *the structure through which the objectives of the company are set,*
- *the means of attaining those objectives*
- *and monitoring performance.*

*It helps define the way **authority and responsibility** are allocated and how corporate decisions are made.”*

**BCBS, Corporate Governance Principles for Banks, July 2015**

## The gameplay set-up:

- ✓ **Players** decide they need to **work together in a structured way** to ensure **game strategies** are properly analysed, selected, implemented and regularly assessed against objectives
- ✓ To achieve this they **put “in writing” a set of roles and responsibilities, authority levels, control mechanisms and reporting lines** and allocate them between Players
- ✓ When **each of them plays its part**, they have bigger **chances to win**, otherwise they are more likely to fall behind; success is never guaranteed

# The Players

## The Shareholders

P1

- The legal owners of the Bank - **they can pretty much change rules for other Players**
- They don't have time to play the full game so **they hire someone to play it for them** (that is Player 2)
- **Once in a while they want to see where they stand.** When results are not good they can change other players in the game (more specifically Players 2 and 3)

## The Board of Directors / Supervisory Board (the “Board”)

P2

- All **selected by Player 1** based on a set of criteria that are meant to ensure a strong team is in place
- They have a **fundamental role to oversee that Player 3 delivers on time and as planned** + doesn't destroy long term value in doing so

## The Management (CEO & team) / Management Board (the “Management”)

P3

- All **selected by Player 2**, although in practice they may be picked directly by Player 1; same flow when dismissed
- Of all the players, **Player 3 is supposed to play the game the most**, come up with game **strategies and tactics**, explain them to Player 1, execute them and report results (ideally over the targets)
- Player 3 is allowed to **hire other specialized players** to implement and execute various parts of strategies

## The Stakeholders

P4

- Player 4 might be a **creditor or depositor, it is a rating agency or a supervisor.**
- The **supervisors** are defining the **play area** and they are also **setting many of the rules of the game**
- Player 4 **has the power to influence the gameplay and behavior** of other Players, being sometimes the most active and important player .
- Also has the right to require lots of information to understand how the Bank is performing, how sound it is, how it is governed etc.

# The Rules

## An evolving set of rules

[1]

2010	2011	2012	2013	2014	2015	2016
<ul style="list-style-type: none"> <li>▪ <b>BCBS</b> Principles for enhancing corporate governance</li> <li>▪ <b>CEBS</b> Guidelines on Remuneration Policies and Practices</li> <li>▪ <b>European Commission</b> Green paper on corporate governance and remuneration policies</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>EBA</b> Guidelines on Internal Governance (GL44)</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>BCBS</b> The internal audit function in banks</li> <li>▪ <b>EBA</b> Guidelines on Fit and Proper (GL/2012/06)</li> <li>▪ <b>BCBS</b> Core Principles for effective banking supervision</li> <li>▪ <b>G30</b> Toward Effective Governance of Financial Institutions</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>NBR</b> <b>Regulation 5</b></li> <li>▪ <b>BCBS</b> External audit on banks</li> <li>▪ <b>European Commission</b> CRD IV/CRR</li> <li>▪ <b>FSB</b> Principles for an Effective Risk Appetite Framework</li> <li>▪ <b>G30</b> A New Paradigm: Financial Institution Boards and Supervisors</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>FSB</b> Framework for assessing risk culture</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>EBA</b> Guidelines on sound remuneration policies (EBA/GL/2015/22)</li> <li>▪ <b>BCBS</b> Corporate governance principles for banks</li> <li>▪ <b>G30</b> Banking Conduct and Culture</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>EBA</b> Draft Guidelines on internal governance</li> <li>▪ <b>ESMA and EBA</b> Guidelines on the assessment of the suitability of members of the management body and key function holders</li> </ul>

# The Rules

## 8 Core Areas covered

[2]

<p><b>Board of Directors</b></p> <ul style="list-style-type: none"> <li>• Core responsibilities</li> <li>• Culture and values</li> <li>• <b>Business &amp; Risk Strategy</b></li> <li>• <b>Oversight</b> of Management</li> <li>• <b>Qualifications &amp; composition</b></li> <li>• Committees &amp; practices <b>1</b></li> </ul>	<p><b>Senior Management</b></p> <ul style="list-style-type: none"> <li>• Core responsibilities</li> <li>• The executive team</li> <li>• Board <b>communication</b></li> <li>• <b>Implementation of strategies</b></li> <li>• <b>Tone from the top</b></li> <li>• Delegation of duties <b>2</b></li> </ul>	<p><b>Group Structures</b></p> <ul style="list-style-type: none"> <li>• <b>Parent</b> company boards</li> <li>• <b>Subsidiary</b> boards</li> <li>• Complex or opaque structures</li> <li>• <b>Proportionality</b> application</li> <li>• Cross-border governance <b>3</b></li> </ul>	<p><b>Risk Management</b></p> <ul style="list-style-type: none"> <li>• <b>Authority, statute, independence</b></li> <li>• <b>Core activities</b> of RM</li> <li>• Role of CRO</li> <li>• <b>Identification. Monitoring and control</b></li> <li>• Risk communication <b>4</b></li> </ul>
<p><b>Compliance</b></p> <ul style="list-style-type: none"> <li>• <b>Authority, statute, independence</b></li> <li>• Acting with integrity</li> <li>• <b>Compliance with laws</b></li> <li>• Compliance with <b>internal normative</b> framework</li> <li>• <b>Play offensively</b> and not defensively when needed <b>5</b></li> </ul>	<p><b>Internal Audit</b></p> <ul style="list-style-type: none"> <li>• <b>Authority, statute, independence</b></li> <li>• Assurance on the <b>overall ICS</b></li> <li>• Review <b>effectiveness and efficiency of processes</b> and controls</li> <li>• <b>Play offensively</b> and not defensively from time to time (advice) <b>6</b></li> </ul>	<p><b>Compensation</b></p> <ul style="list-style-type: none"> <li>• Role of <b>Rem Committee</b></li> <li>• Key function holders and material risk takers</li> <li>• <b>Alignment with business and risk strategy</b></li> <li>• <b>Performance</b> management</li> <li>• Variable remuneration <b>7</b></li> </ul>	<p><b>Transparency &amp; Disclosure</b></p> <ul style="list-style-type: none"> <li>• Define roles and authorities</li> <li>• Identify stakeholders</li> <li>• Identify needs</li> <li>• <b>Mandatory disclosures</b></li> <li>• <b>Additional disclosures</b></li> <li>• Underlying processes and controls <b>8</b></li> </ul>

# The Gameplay

## The Board: embracing an active role

- A **strong and effective Board (Player 2)** should have a **clear view of its role in relationship to the Management team (Player 3)**
- The focus is **primarily on guidance and strategic issues**, the **selection** of the CEO and other members of the Management, **risk oversight** and **performance assessment**, and adherence to legal requirements
- Player 3 (**Management**) implements the **business strategy and runs the Bank's day-to-day operations** with the goal of increasing Player 4's (shareholder) value for the long term
- **The role of the Board in strategy** can be either **an active one** (articulation of strategic direction) **or a passive one** (review and approve proposals from management)
- The **current regulatory framework has shifted** more towards the **need of an active board**, especially with regards to **risk strategy** definition and oversight

[1]

### **Board Responsibilities**



# The Gameplay

## The Board: embracing an active role

[2]

### *Challenges facing boards' oversight of key risks*



How can the board make sure it is spending its time focusing on the right issues?



**Board action:** Work with management to make sure that the board devotes its attention to the truly critical risks and be skeptical when probing whether management is addressing those risks adequately.



How can boards recognize when a key risk may be about to materialize?



**Board action:** Regularly discuss how management tracks whether risks are changing or are becoming more likely.



How can directors connect the dots across key risks to understand how they interact?



**Board action:** Devote discussion time to how key risks interact with each other to get the full picture of uncertainty.



How can the board monitor reputation risk?



**Board action:** Ensure that the company monitors social media and looks for other indicators that the company's reputation may be suffering.

# The Gameplay

## The Board: embracing an active role

[3]

### *Key challenges directors face when overseeing ERM*



How can directors know if ERM is adding value?



**Board action:** Dig into how well ERM works and whether changes should be made.



How can the board ensure that executives take their responsibility for risk seriously?



**Board action:** Discuss with senior management how they have put ERM into practice, including who's accountable for key risks and how ERM works at lower levels in the company.



How can the board better understand what risks may emerge in the future?



**Board action:** Push executives for regular forward-looking, strategic input on emerging risks.



How can the board get the reporting it really needs on risk?



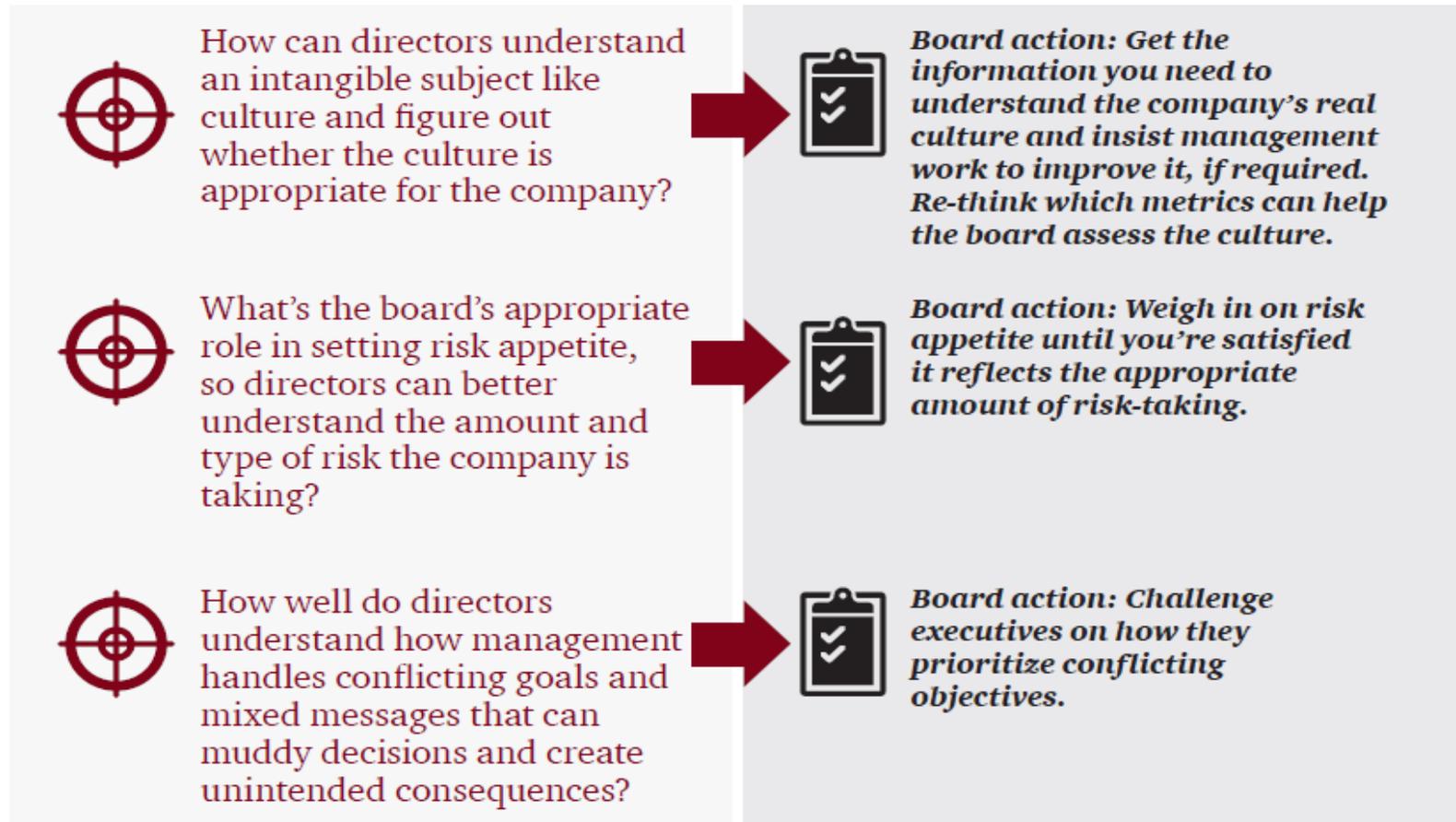
**Board action:** Be clear on the kind of risk information you need from management and how often you want to see it.

# The Gameplay

## The Board: embracing an active role

[4]

*How can the Board influence culture and risk appetite?*

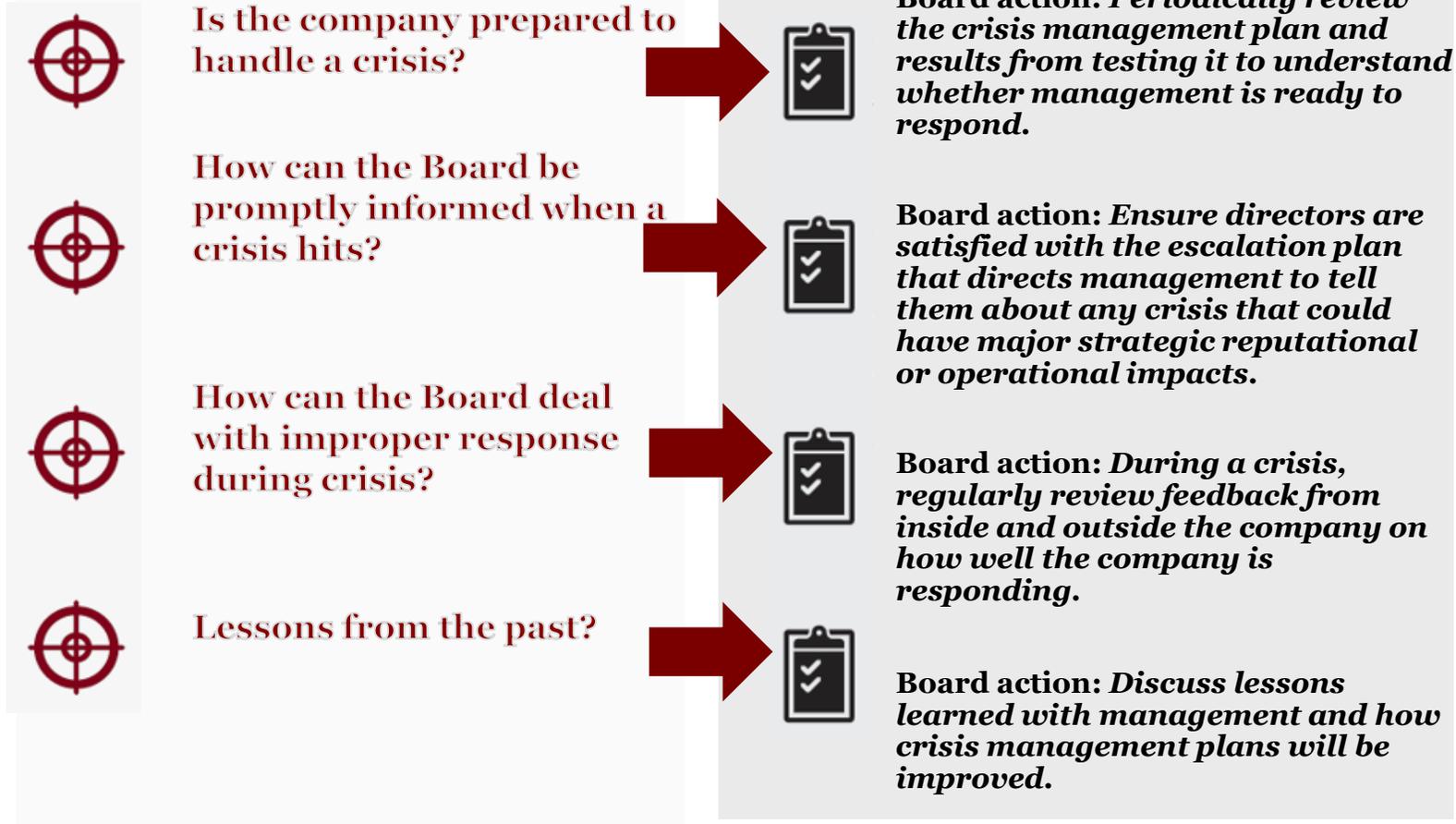


# The Gameplay

## The Board: embracing an active role

[5]

### *How can the Board be ready for a crisis?*



# The Gameplay

## The CEO: the Chief Everything Officer

*The CEO means the **person who is responsible for managing and providing steering** to manage the overall business activities of an institution (EBA GL44 revised).*

- **Player 3 (CEO and Management) is responsible for the day-to-day management but Board retain responsibilities for oversight and monitoring** (...good reason to **stay informed and connected to the realities** of the business)
- **The CEO is leading the Player 3 team**, and is a central figure in any institution, a key **interface with all Players** in the game
- **Player 3 (Management) implements the business strategy and runs the Bank's** day-to-day operations with the goal of increasing Player 4's (shareholder) value for the long term
- **To ensure long term success the "Chief Everything Officer" has several key roles to play**, such as:
  - ✓ **keep the Board involved and informed** on the **strategic plans** implementation
  - ✓ build, lead and motivate a **team of experts** in the **implementation of the strategy**
  - ✓ **inspire everyone** in the institution to **on-board the mission and vision** of the Bank
  - ✓ **set an example of appropriate conduct**, even in difficult situations
  - ✓ **communicate externally** with customers, regulators, investors and other stakeholders
  - ✓ in the end, **meet targets/ objectives to keep all Players happy** (and thus have time to deal with above points...)

# The Gameplay

## The Control Towers: are control lines purely defensive?

[1]

### 01

#### A USEFUL FRAMEWORK

**Three lines of defence (3LoD) is a useful model for defining the approach to risk governance.** However, it is not always well understood, articulated or implemented.

Clear **separation between:**

- **1<sup>st</sup> line players** - business units: own and manages risk
- **2<sup>nd</sup> line players - control functions** (risk management and compliance): provide risk oversight, compliance monitoring and the oversight of risk across business areas
- **3<sup>rd</sup> line players - internal audit:** providing independent assurance of the overall effectiveness of the risk management framework

### 04

#### IMPLEMENTATION CHALLENGES

The challenges attributed to the model **as a result of the financial crisis** were : (i) failings of implementation with, in particular, **a failure to achieve #2 above**, but also (ii) **a failure of the 2<sup>nd</sup> line to apply its veto to excessive risk taking.**

**The big challenge is the proper accommodation of the roles attached to the 1<sup>st</sup> line of defence.** The concentration of technical knowledge in the second line is an important factor here as it can result in 'ownership' itself not being consistently understood.

### 02

#### ESTABLISHING OWNERSHIP

Establishing **ownership and management of risk within the business is essential** to successful implementation of the 3LoD.

**The 2<sup>nd</sup> line functions cannot compensate effectively for failings in the 1<sup>st</sup> line** ownership and management of risk, other than by constraining their ability to take it.

Consequently:

- **the majority of controls should operate within the 1<sup>st</sup> line.**
- Adequate segregation of duties required.

### 03

#### GUIDING PRINCIPLES

**3LoD is best seen as a series of guiding principles** which drive the establishment of roles and responsibilities of individuals and functions.

**There is not a singular right answer and structures may vary across organisations, businesses and risk types.**

In particular, it is **essential to have a risk language which is understood and used consistently.**

### 05

#### LONG SHOT BENEFITS

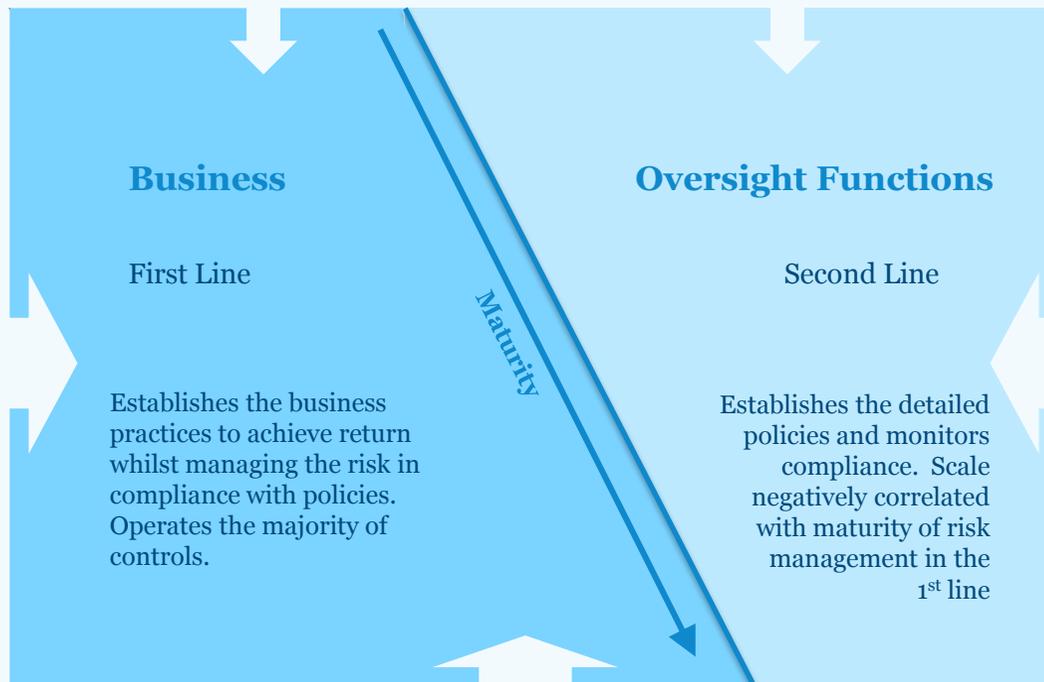
Sound operations of 3LoD might lead to a reduction of the resources on a long term.

# The Gameplay

## The Control Towers: are control lines purely defensive? [2]

### Governance (Board, Board Risk Committee and Audit Committee)

Establishes the strategy, operating model and risk framework. Evaluates reports



### Internal Audit

Third Line

Provides independent assurance on the processes for establishing strategy and risk appetite, the embedding of the framework and the effectiveness of controls and control functions

The three lines of defence model distinguishes between three groups of players involved in effective risk management separating functions that:

- Own and manage risks
- Oversee risks
- Provide independent assurance

The Business, or 1<sup>st</sup> line, should own and manage the risk.

The control functions, or 2<sup>nd</sup> line, establish policies and limits for the 1<sup>st</sup> line which align with risk appetite as set by the governance structure. It may also control risk in aggregate by risk type.

The 3<sup>rd</sup> line, internal audit, provides assurance on the effectiveness of processes and controls.

# The Future – 7 challenges

1. **Regulation overdrive** already happening around Governance (multiple EBA initiatives)
2. **Challenges** triggered by the **independence requirements for the Board members**
3. **Scrutiny of supervisors around strategic risk is picking up** (e.g. see Business Model Analysis under SREP, including burdensome documentation requirements)
4. Challenges to create **incentives on performance target in an overregulated environment**
5. **Regulatory compliance risk to reach top 5** (i.e. inability to manage regulatory change agenda effectively and on time)
6. **Disclosure requirements** (under Pillar 3) will put much **more data in the open field** (some of strategic nature...). Quantity will not prove better than quality
7. Potential for rise of a **Chief Governance Officer?**

