

Corporate governance of financial institutions
Speech in Copenhagen on 9th June, 2010

A little more than 20 years ago, the Iron Curtain fell and totalitarian rule in Eastern Europe and the Soviet empire came to an end, a sequence of developments of massive global significance. The particular relevance of all this for corporate governance is that, as a result of the transition to greater democracy in the world alongside the globalisation of production, trade and capital markets activity, the boards of many major corporations now exercise power second only to that of elected governments and, indeed, in excess of that available to the governments of many smaller countries.

In Europe, the United States and elsewhere in the developed world, the original purpose of the board was to protect and advance the interests of all shareholders. Subsequently, and particularly recently, new accountabilities have been added by statute and regulation in areas as diverse as health and safety, employment and pension rights, the form and detail of financial accounts, environmental impact, competition and anti-trust..... and there are many others, specific to particular business sectors. In banking, insurance and other financial institutions the social externalities associated with serious problems or failure are internalised through financial regulation, and major initiatives, national and international, are currently in train both to intensify and to extend its reach. This reflects an understandable and rational political reaction to the massive damage inflicted on society above all through lost output and growth but, also, the burden on taxpayers, who have found themselves saddled with unlimited liability in situations in which the liability of owners of failed entities was limited to the loss of their equity stakes.

The political, Main Street and media mood still retains a strongly retributive flavour. And there is schizophrenia in the twin political aims of ample, cheap credit and safe banks – which are unlikely to be simultaneously achievable. What is clearly important is that new policy prescriptions are based on objective, authoritative and coherent diagnosis so that what is put in place yields sustainable improvement at the critical interface between public policy and private enterprise. If policy measures are not properly thought through and if appropriate balance is not achieved, the unintended consequences could in the event be seriously negative, for example in diverting disproportionate entrepreneurial energy into regulatory and tax arbitrage; and in making major financial institutions materially less attractive to investors and thus less able to play their critical role in the provision of credit and other financial services on which all other business relies.

There are in any event specific constraints on what legislation and regulation can achieve. Legislation created legal personality and limited liability for shareholders and lays specific accountabilities on boards of directors. But

corporate governance in a market-based economy is ultimately in the hands of directors and shareholders. Regulation cannot substitute for board decisions and, while it might limit, it cannot determine the extent of engagement by owners.

I do not propose to discuss capital and liquidity requirements, contingent capital and other resolution mechanisms, restrictions on the scope of banking business or the taxation of banks, topical and prominent as these subjects are on the political and public policy agenda. I imagine that some of you might share my concern that there is a risk that the pendulum swings too far with many of these public policy initiatives. But the credibility and justification for such concern clearly depends in part on the reliance that governments and regulators can realistically place on improved corporate governance in mitigating the risk of any recurrence of the massive cumulative failures that produced the recent crisis.

The record of corporate governance on the part of both boards and owners was palpably inadequate in the period before catastrophe struck in failed entities on both sides of the Atlantic. My focus now is on three major areas where I believe that material improvement is both needed and achievable, and I note that the European Commission has just published a green consultative paper on this. The terms of reference of my review were limited to banks and other financial institutions. But I will suggest at the end that many of my conclusions might be applied with little modification to the governance of all corporate entities. I want to suggest also that, despite some formal differences between board structures in Denmark and the UK - in particular, Danish boards have employee representation and executives are not formally members of the boards of their companies - the most substantive difference in corporate governance overall stems from the degree of control exercised by foundations as major shareholders in several major Danish entities. I will revert to this within the third of the key corporate governance areas on which I want to comment.

The first key area relates to the dynamic of the boardroom. Whatever the capability of the outside members of the board in terms of industry knowledge, this will be of only limited value unless the boardroom environment is one in which challenge of the executive is accommodated, encouraged and indeed expected as a normal part of strategic discussion. As I see it, the chief executive should be at the beginning and end of the process. It is for the executive to launch a strategic proposition; to be followed by challenge and rigorous review of the proposition in board discussion leading on to a board conclusion on the course to be followed; and then, at the end of the process, full empowerment of the chief executive to implement the agreed strategy. The role of the chairman is pivotal in all this. If he or she is too defensive of or at loggerheads with the CEO, the board will not work effectively, and either positive strategic opportunities will be missed or ill-considered strategies will be adopted.

The core task for the chairman is to promote an appropriate behavioural dynamic within the boardroom in which challenge is encouraged and, ultimately, those who are incapable of contributing to it are sidelined or removed. This is why I have placed such emphasis on the role of the chairman in ensuring that the board is of an appropriate size, in countering group-think and in providing transformational rather than transactional leadership. All this led me to propose the tough discipline on a chairman, and on those who appoint him or her, that the role should be subject to annual election.

This proposal has been quite widely criticised as promoting short-termism. But I would take the opposite view and argue that the role of the chairman is so pivotal that any deficiency in leadership in delivering effective board performance cannot and should not be allowed to persist for long; and that engagement between shareholder and the chairman or senior independent director is more likely to take place and to be constructive if all parties know that there is the ultimate option of removing the chairman at the AGM. My hope and expectation would be that well-informed engagement by fund managers complemented by the power to vote against an incumbent chairman should lead, where this is required, to timely course correction on the part of the board and that the question of removal of the chairman through a negative vote comes up only infrequently.

The second key area relates to financial risk, the core engagement and activity of any BOFI business. Leverage in the BOFIs that failed, and in many others, was, as we all now know, grossly excessive in the build-up to the crisis. While prudential supervision was inadequate, boards and fund managers, egged on by the analyst community, were at least tacitly committed to, if not actively pressing for, what was seen as more efficient balance sheet management and higher leverage to fund share buybacks. My recommendation is that all major BOFI boards should have a board level risk committee, to advise the board on risk appetite and tolerance as core elements in the strategy of the entity.

I have heard the argument that risk matters should be left to the executive risk committee, largely on the basis that non-executives cannot reasonably be expected to master the complexities of a modern major financial group. There was also argument before the crisis that outside board members need not be overly concerned with risk matters in respect of business where an internal model, blessed by the regulator, was being used to calibrate appropriate balance between risk and the available capital buffer. I find such arguments seriously misconceived. If a group's business is beyond the comprehension of the board then either there needs to be change in the board or, alternatively, the business of the group needs to be restructured or simplified so that it is amenable to effective board oversight. I am not of course suggesting that the board's risk committee should be confronted with large amounts of granular risk data. The committee will only function effectively if it is served by a chief risk officer who is expert in

the business; is capable of presenting major issues for board level focus and decision is a thematic way; and who enjoys appropriate independence from the executive.

Before the crisis, risk governance arrangements of this kind were in place in less than half of major BOFIs on both sides of the Atlantic. I believe introduction of more effective board oversight in this area as I have recommended should materially reduce the risk of build-up of vulnerabilities in individual entities of the kind seen before the recent crisis. I do not accept the argument that this cannot be done. It is being done in some major BOFIs already on much the lines that I have described.

The third area, that of engagement between owner and board, is in many ways the most sensitive and difficult. Although the form of the agency problem differs among countries, a common feature is that the agency gap between the ultimate beneficial owner and the board as agent in the listed company has widened substantially. This is the result of the reduced presence in the equity space of naturally long-only holders such as life assurance and pension funds; the increasing interposition of the fund manager between ultimate shareholder and investee company; as regulation circumscribes the scope for communication between board and fund manager; and as business models geared to short-term equity trading performance have become greatly more significant.

One result of the attenuation of investor interest in holding longer-term stakes is that boards have less knowledge of and confidence in the stability of their shareholder base and, as an almost inevitable consequence, time horizons for board strategies have been foreshortened. To the extent that such myopia has developed, there is an opportunity cost for society at large as the balance in decision-taking is defensively skewed against longer-term commitment. Paradoxically, whereas successful transition from the high inflation and high interest rate environment of 20 years and more ago has reduced one major driver of quick payback strategies, much of the change over the past two decades in the configuration of fund management business has driven in precisely the opposite direction.

It is this, I acknowledge very summarily, reading of the problem that led me to suggest in the UK environment that beneficial owners and fund managers have an implicit social obligation to be much more attentive to these issues. In particular, I have recommended that fund managers be obliged to make clear disclosure of their business model, and specifically whether they commit to a code of stewardship, as initially promulgated by the Institutional Shareholders' Committee in the UK. My purpose has been to ensure that, in placing a mandate with a fund manager, an ultimate owner or trustee is aware of the investment style to be followed and is better able to make an informed decision on the basis of the

