The New Corporate Governance in Banks

Geoffrey Parsons Miller
Stuyvesant Comfort Professor
Director, Program on Financial Institutions
Co-Director, Program on Corporate Compliance and Enforcement
New York University Law School
New York, New York USA

Remarks at the Conference: Challenges of Financial Regulation in the 21st Century
São Paolo, Brazil
December 8, 2015

Corporate governance in banks in the first part of the 21st Century is transforming into a new model which differs in important respects from earlier approaches.

This new corporate governance is not a revolutionary change: many aspects of older approaches remain in place. But it does represent a change of emphasis and a significant adjustment of powers and responsibilities.

Let me start by defining terms.

The term "corporate governance" refers to *how decisions are made* within and for complex organizations.

There are two aspects to the idea of corporate governance.

● Descriptive: who *actually* decides?

● Normative: who *should* decide?

My remarks today are directed at this second question: who *should* decide.

<u>The goals of corporate governance at banks</u>

The question who should decide a simple question, but unfortunately it doesn't have a simple answer.

To identify who should decide, we need to identify the person or group for whose benefit the decision is made.

So, whose interests are we serving when we assign governance rights?

The problem is that there are four principal candidates for the position: managers, shareholders, depositors, and the public.

● Managers (CEO and other executives).

Managers have a claim to be the class of people for whose benefit corporate governance decisions are made.

- They are most involved in making decisions for the bank.

- They know the most about the bank's opportunities and risks.

- Their reputations are tied to the fortunes of their bank.

- They have undiversified personal wealth invested in their bank.

- If things go wrong, they face possible liability for the losses incurred.

One might imagine, therefore, that the solution to the "who should decide" problem is that we should simply allow managers free scope to make decisions without outside interference.

But there are obvious problems with making managers the beneficiaries of corporate governance:

- Since they control the bank, they are likely to pay themselves too much.

They may give themselves below-market loans or engage in other conflicts of interest.

They may consume excessive perks (golf club memberships, private jets, etc.).

They may be lazy and not manage the bank well.

For these reasons, corporate governance reforms always take the form of efforts to limit the power of incumbent managers. But whose interests should be taken into account when the power of managers is limited?

● Perhaps governance reforms should serve the interests of shareholders.

This makes a lot of sense:

Shareholders are the "owners" of the bank, and we ordinarily think that owners should control what is done with assets they own.

Shareholders are exposed to risk of operations both upside (profits) and downside (losses).

Shareholders' incentives line up with that of society as a whole insofar as they want their bank to make a profit.

In the absence of governance protections, shareholders of large financial institutions have only limited ability to protect themselves against self-interested behavior by managers.

On the other hand, there is a big problem with making shareholders the beneficiaries of corporate governance:

Shareholders enjoy limited liability. They get the entire upside if the bank does well, but they incur losses only to the value of their investments.

In consequence, shareholders are too risk-preferring. If governance decisions were made with only shareholders in mind, banks would take on too much risk.

For this reason we do not want corporate governance at banks to take account only of the interests of shareholders.

● Perhaps governance reforms should serve the interest of depositors.

This also makes a lot of sense:

Most of us would agree that people should have a secure place for their savings and that banks should offer that assurance in the form of deposit accounts.

Most would also agree that people should have access to a safe and secure mechanism for making payments and that banks should offer that service.

Depositors are disorganized and not well positioned to protect themselves by contract, so they need the protection that governance reforms can offer.

On the other hand, there are obvious problems with making depositors the sole beneficiaries of corporate governance at banks.

Depositors don't share in the profits. This means that depositors are strictly risk-averse. This is not what society would want for banks: if banks were strictly risk averse they would not provide financing to people with new ideas.

Moreover, depositors are have no incentive to ensure that a bank follows the rules, doesn't behave unfairly towards borrowers, doesn't engage in money laundering or finance terrorists and so on.

For these reasons, we do not want corporate governance at banks to take account only of the interests of depositors.

● Perhaps corporate governance of banks should serve the general public.

This also makes a lot of sense.

But making the public the beneficiary of corporate governance at banks isn't very satisfactory either.

The problem is that the idea of the public interest is so diffuse that it is almost useless as a guide to decisions.

In practice, decisions officially made with the public interest in mind usually benefit one or more special interests, so the idea of the public interest tends to collapse into one or another of the groups whose interests don't align fully with the interests of the public as a whole.

<u>Older corporate governance initiatives</u>

The essential problem of corporate governance in banks, therefore, is that while we believe that decision-making processes at banks need to change, we are not sure how to do it.

In the United States the following ideas have successively attracted the enthusiasm of the advocates of governance reforms.

● Increasing the independence of the board of directors.

This is a good idea – independent boards can act as a countercheck to incumbent executives.

But independent board membership requirements didn't work very well because CEOs found ways to dominate and control independent boards.

● Takeover bids.

This is a good idea because the threat of takeovers incentivizes managers to optimize the use of bank assets. But takeover bids never reached their potential because incumbent managers found ways to defeat them. And in the case of banks, there were too many regulatory obstacles to make takeover bids an effective disciplinary device in the first place.

● Incentive compensation systems.

Incentive compensation systems are a good idea because they reward executives for good results and penalize them for bad results. But these did not work out well because they also incentivized bank managers to take on inappropriately high levels of risk – risks that contributed to the global financial crisis of 2007-2009.

● Relying on institutional investors such as pension funds and investment companies.

This is a good idea because institutional investors have the incentive and the power to monitor managers and to encourage them to perform well. But this idea did not reach its potential because most institutional investors remained passive and did not take on a monitoring role.

● Enhancing the role of external auditors.

This was a good idea because external auditors get to look inside and evaluate whether a company has an effective system of internal controls in place. But in the view of many, enhanced audit requirements didn't work out as hoped because they increased costs of audits without necessarily contributing substantially to the quality of management.

● Enhancing the authority of the board of directors -- for example by creating specialized committees; establishing skills and education requirements for board membership; or splitting of the offices of chairman of the board and CEO.

These are good ideas because a board of directors which is expert and empowered can present a credible challenge to bank management. But so far there is little evidence that enhanced board powers have had much effect.

● Enhancing the power of stockholders -- for example through activist investors; proxy advisory firms; shareholder votes on executive pay; and proxy access rules that allow shareholders to nominate candidates for election to the board.

These are good ideas because they elevate shareholder influence. But, although it is too early to make a definitive judgment, so far there is little evidence that these reforms have accomplished much. Pay packages for senior executives did not change much after say-on-pay rules came into effect; and recent efforts to separate the positions of the CEO and Chairman have failed at JPMorganChase and Bank of America.

So the options tried in the past have not really worked out. But whenever one reform seems played out, another always rises up as a new candidate for optimal corporate governance.

The new corporate governance at banks

Today, it appears we may be witnessing the birth of a new set of reforms. There are two principal characteristics of this new corporate governance of banks.

● First, the new corporate governance is *polycentric* in the sense that it empowers new actors as key participants in the governance process.

● Second, the new corporate governance of banks is *risk-based* in the sense that it is premised on an assessment of the risk posed by a particular activity or function.

Let's explore these.

Polycentric:

The new corporate governance of banks brings at least three new players into key decision-making roles: C-Suite executives; professional consultants; and bank regulators.

● C-Suite:

In the years since the financial crisis, financial institutions in the United States have greatly upgraded the authority of certain officials in the so-called "C-Suite" – officers with the word "chief" or equivalent in their job titles.

First, the Chief Audit Executive. The head of internal audit has been empowered under the new governance system. Audit heads today commonly report to the board audit committee rather than to an executive official. The budgets and staffs of CAEs have been increased and a broader range of topics have been brought under their audit responsibilities.

Next, the Chief Compliance Officer. The CCO is no longer a subordinate in the GC's office but head of his own office. Staffs at compliance departments have grown spectacularly; JPMorganChase announced in 2014 that it was in the market to hire 3,000 new compliance officers worldwide. In some cases the CCO reports to the audit or compliance committee of the board of directors; and even if such a reporting line doesn't exist, the CCO enjoys rights of access to board committees, typically including a guarantee of private time with directors.

Third, the Chief Risk Officer. CROs today are given staff and substantive powers sufficient to ensure that the bank's activities remain within the risk appetite set by the board of directors. The CRO may report to a relevant board committee (typically the board risk committee), or at least enjoys the right to communicate privately with board members.

Internal audit, risk management, and compliance are becoming recognized as independent professions in their own right, with the status and powers associated with that form of organization.

Moreover, each of these positions is increasingly recognized, not just as a provider of a service, but more fundamentally as a player in the formulation of strategic policy.

So internal audit, compliance, and risk management are beginning to be important parts of governance in financial institutions.

● Professional service providers:

The second category of individuals who are playing a new role in governance of banks is third party professional service providers.

Attorneys are one example. When a bank learns of potential serious compliance violations or other breakdowns of management processes, it may decide to retain the services of an outside attorney to perform an investigation. The retention of an attorney under these conditions represents a transfer of governance power, because as a practical matter a bank that entrusts such a matter to an attorney loses the power to control what the attorney-investigator does, or the reforms that the attorney-investigator may call for as a consequence of the investigation.

Compliance monitors – who may or may not be attorneys – are another example.

Monitors are often appointed as part of a consent agreement between a bank and a regulator. Monitors enjoy rights of access to information, guaranteed tenure in office and financial support, and the authority to report back to the government regulator what they observe.

Attorneys, compliance monitors and other professionals are also, therefore, playing a role in the new corporate governance of banks.

● Regulators:

The third group who play a role in the new governance of banks the bank regulators.

Regulators tend to reject this idea. Talk to a regulator and you are likely to hear a denial that the regulator wants to govern banks – that function is up to the bank itself, the official will say.

The reality, however, is that regulators are taking on ever greater management functions.

U.S. regulators, for example, recently issued and made available to banks a cyber risk assessment tool. This is only a recommended approach: banks are not required to adopt it. But when a regulator makes a recommendation, it is advisable for a bank to comply, since if they do not, they face an increased likelihood of criticism during the next bank examination.

Other bank activities now subject to this sort of regulatory guidance include enterprise risk management, internal audit, model risk, interest rate risk, credit risk, operational risk, and cyber risk.

Regulators and lawmakers have also started to influence how key decisions are made at banks. For example, regulators require that the board of directors of banks include an audit committee which should include members who are expert in financial matters. Larger banks are required to host risk committees that include at least someone with expertise in risk management. Regulators strongly suggest that the head of a bank's internal audit department should have a direct reporting line to the audit committee of the board. And so on.

By influencing how banks undertake key processes and functions, regulators are taking management decisions onto themselves, and for this reason can be considered as de facto partners in bank corporate governance.

So far I have described the polycentric nature of the new bank governance. There is another key element: the new governance is *risk-based*.

All key players in bank governance act on the basis of a risk assessment pertinent to the matters over which they have responsibility.

For example, bank directors are expected to consider and adopt a risk appetite statement which incorporates key metrics and defines the levels of risk that a bank is comfortable taking on and to monitor whether the bank is in compliance with its risk appetite. Larger banks operate board risk committees that spend much of their time dealing with this task.

The Chief Risk Officer is charged with implementing and monitoring the bank's risk levels and its conformity with the board-adopted risk appetite statement.

The Chief Audit Executive is expected to perform his own, independent risk assessment and to design the bank's audit plan on the basis of the risks so identified.

The Chief Compliance Officer also conducts a risk assessment to determine the severity and likelihood of violations in areas under her responsibility.

External actors also assess risk at the bank.

The external auditor, for example, is expected to make a risk assessment pertinent to the audit task, identifying areas of greatest concern in the integrity of the bank's system of financial reporting and evaluating these areas most intensively in the conduct of the audit.

Government officials also make risk assessments. Bank regulators, for example, schedule examinations and assign resources to supervision based on an assessment of risk at the bank.

So these are the elements of the new governance in banks: polycentric governance and risk-based approaches. As I mentioned, these developments do not replace the older forms of bank corporate governance. Rather they represent a modification that empowers new players and changes the emphasis or focus of governance activities.

Policy objectives of the new corporate governance of banks

We can understand these reforms with reference to the policies of corporate governance discussed earlier.

Earlier initiatives in corporate governance limited the powers of bank managers with a view to serving the interests of either shareholders, or depositors, or both.

The new bank corporate governance is based on somewhat different policies.

These changes have largely been responses to the poor performance of banks surrounding the global financial crisis of 2007-2009. The perception growing out of that crisis is that banks took on too much risk and did not consider the public interest sufficiently in their investment and management decisions. The new bank corporate governance, therefore, places the interest of the general public at the center of the policy space.

Most of the players who have become prominent in governance can be seen, in part, as serving this goal.

The newly empowered C-Suite executives are all internal control officials whose responsibilities run to the public as well as to the bank.

Professional service providers such as attorneys performing investigations or monitors supervising banks to ensure compliance with regulatory settlements help ensure that the bank complies with applicable regulations and laws.

Similarly, the regulators have an explicit mandate to serve the public interest when they play a role in the new corporate governance of banks.

Same with risk management: the new focus on risk management is designed to serve the public interest in ensuring the stability of the financial system.

So the new, post-crisis corporate governance of banks, unlike the governance reforms tried earlier, is specifically directed at the public interest rather than at protecting shareholders or depositors.

Assessment of the new corporate governance of banks

I conclude with a brief assessment.

Is the new polycentric, risk-based governance at banks likely to perform better than the former system?

There is some reason for some optimism on this score, since these changes appear designed to respond to problems that came to light during the financial crisis.

But several considerations also suggest caution about whether this new governance system will solve governance problems at banks.

● Prior disappointments: The history of prior reforms suggests that even the best intentioned and most promising governance reforms often fail to achieve their apparent promise. There can be no assurance that the new corporate governance at banks will be different.

● Costs: unlike earlier reforms, these new reforms are quite costly to implement. Banks have had to hire thousands of new employees and comprehensively revamp their systems of internal controls.

There can be no assurance that these expenditures are cost effective. The regulators who insist on the reforms do not pay for them, and so are not likely to be very sensitive to cost concerns. The third party service providers to play a role in new governance – attorney investigators and monitors – have effectively unchecked power to run up the bills because when they are appointed the bank cannot appear cheap about paying them.

● Erroneous risk assessments: the risk-based approach to governance has a great deal of promise, but it also has one very serious flaw. Risk assessments can be wrong. In the financial sector, they often are wrong.

Consider how many observers in 2006 would have listed the risk of a catastrophic liquidity crisis as one of the top dangers facing the financial system. Almost none. Yet that is exactly what happened.

If our risk assessments are wrong, we are likely to be worse off than if we had never made a risk assessment in the first place.

● Migration to the unregulated sector: To the extent that the new corporate governance regime imposes excessively binding constraints on banks, essential financial services are likely to migrate to the less regulated shadow banking sector, or even to the illegal sector. This would potentially be harmful to the public interest, not helpful.

● Inhibition of innovation: The new corporate governance at banks is associated with a reduction in innovation and a homogenization of practice. But innovation is necessary if we are to move forward to take account of rapidly changing circumstances in the banking sector.

This is a special concern today because banking may soon be facing an existential challenge to its core functions and purposes.

Commercial banks do two basic things: they are financial intermediaries (they make loans) and they provide payments services (they offer demand deposit accounts).

Each of these functions is under technological threat.

Financial technology firms are beginning to cut into the core banking business of making loans.

Lending Club, one of the leaders in the U.S., is an online marketplace that connects individual lenders and borrowers. To date it has arranged for more than $13 billion in financing and its growth rate has been spectacular.

Crowdfunding is another example – a way users of liquidity can go directly to providers without having to use banks as intermediaries.

Meanwhile most central function of banks – providing payment services through demand deposit accounts – is also under threat. Blockchain or distributed ledger technology, pioneered in the innovative digital currency Bitcoin, has exploded beyond its original roots and is now poised to represent for payments and settlement services what quantum computing may be for the computer industry.

Banks, to be sure, are struggling to keep up with these innovative technologies – investing billions of dollars in the effort – but they are not nimble institutions. It will be hard for them to maintain leadership positions if these new technologies become mainstream. And the new corporate governance of banks, with its focus on protecting the public interest and avoiding risk, is not likely to be of service.

* * *

Overall, therefore, it is fair to say that banking is in the midst of yet another change in governance strategies – one that has not yet been fully recognized, but also one that will exert an influence in the years to come.

Specifically, corporate governance in banking is becoming polycentric and risk based.

This change has a great deal of potential for good, but there are also reasons for skepticism about whether it will reach its objectives, or indeed whether it will possibly interfere with banks' ability to adjust to rapidly evolving technological and marketplace changes.

Many thanks for your attention.