Genoa Centre for Law and Finance

European Commission: Green Paper Corporate Governance in Financial Institutions and Remuneration Policies

26 November 2010

Response to the European Parliament

We appreciate the opportunity to respond to the specific questions raised by the European Commission in its Green Paper and further selected by the European Parliament.

Introductory note:
We suggest avoiding terms such as "prohibit" and "compulsory"; the Commission's document should be viewed as providing guidelines as to best practice corporate governance principles and standards to be adopted by financial institutions, rather than binding rules.
Corporate governance principles should be adopted based on the principle of proportionality. This means that their implementation should be proportionate to the size and complexity of institution (when applied beyond the limited set of international significant institutions), the structure, the nature of their business model and activities, and the risk profile.
The supervisory authorities' monitoring the implementation of principles should be tailored to financial institution's individual characteristics.

A. Role of the board

1.2. Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

It is advisable that the chair of the board and the chief executive officer are not vested in the same person.
Given the crucial role played by the chair of the board in achieving appropriate checks and balances, it is advisable that the chair of the board be non-executive, to avoid possible internal conflicts of interests. In case the two roles are shared, it is important for the institution to have measures in place to minimise the impact of such conflicts of interests (for example by appointing a senior independent board member).
This is applicable not only to financial institutions, but across industries.

1.3. Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse?

Board members should be able to exercise sound and objective judgement regarding the activity of the institution.
Given the close involvement of the board in the bank's strategy, governance, risk and control, the board should individually and collectively possess appropriate professional and personal qualities, i.e. expertise in finance, strategic planning, risk controls, governance, financial regulation. These skills can be enhanced also through training, however fundamental knowledge being necessary.
Independence of judgement – an essential requisite – can be enhanced by recruiting members from a sufficiently broad population of candidates (diversity).

1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

An appropriate involvement and performance of the board in ensuring a proper corporate governance framework for the institution should already set the tone for an efficient supervisory system. However, to support board performance, it is good practice for the board to carry out individual and collective assessment of performance. This should be done regularly and should also include reviews of its own procedures. External evaluators may contribute to the objectivity of the process.

1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

Especially in large complex financial institutions, special committees (including risk committee) should be established for matters where the potential for conflicts of interest is greatest. It is important that members of the risk committee exercise independent judgement, therefore be compensated independent of their business units.

Reference: Financial Services Board, "Principles for Sound Compensation Practices. Implementation Standards", September 2009.

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

Exchange of information between the special committees is important, and this could be enhanced by common membership.
However, to enhance effectiveness of the risk committee, proper communication flow should be established with the risk management function, with the internal control and compliance functions. Where necessary, the risk committee could receive independent external advice.

The Audit Committee and the Risk Committee (where both exist separately) should undertake to review the company's internal control and risk management systems.
What is important is that, in order to achieve a high degree of objectivity, members of the risk committee be composed of non-executive and majority independent members.

Reference: The Turnbull Guidance, published alongside the UK Combined Code of 2003, provides measures for a review of financial, operational and compliance controls to be performed at least annually.
See Financial Reporting Council, "The Combined Code on Corporate Governance" 2003 and 2006.

1.8. Should the chairman of the risk committee report to the general meeting?

Efficient communication through reporting and advice to the board should foremost be established. The board will report the outcome of the risk committee at the general meeting of shareholders.

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

Boards are responsible for approving institution's exposure to risk (risk appetite and risk tolerance) and its risk policy. These need to be connected to an appropriate risk management methodology, based on an established risk management process. Boards will review the institution's risk exposure and policy regularly, in line with any changes in business strategy or external market conditions.

1.10. Should a risk control declaration be put in place and published?

"Declaration" and "statements" have not always succeeded in increasing the level of compliance, often becoming boilerplate declarations.
More important is the access by the board to risk information provided by the management with regards to identified risks and measures to execute strategy and risk processes. A risk policy and risk management process should be established.

Reference: Ferrarini, Niamh Moloney and Maria Cristina Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis", ECGI Working Paper 126, 2009.

1.11. Should an approval procedure be established for the board of directors to approve new financial products?

Launching of new financial products is part of financial institutions' strategy and the main potential issue is the risk exposure of these products.
Effective internal control systems and risk management functions are the first filter of checking the financial products. Furthermore, boards' functions include monitoring and ensuring that management's actions are consistent with the strategy and policies approved initially by the board.

1.12. Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

This is part of the governance framework of the financial institution.
Sound corporate governance already contributes to ensuring an efficient supervisory system, permitting the supervisor to rely to a higher degree on the institution's internal processes. Therefore, appropriate levels of accountability and effective checks and balances ensure high level of trust between the institution and the supervisor. Internal controls should also determine the level of compliance with company policies and procedures, and with regulations.
Transparent internal communication is the next condition for achieving effective risk management; this is done across the organisation (horizontal communication) and through reporting to the board and senior management (vertical communication).
Especially when the institution experiences problems, the supervisor may place additional requirements on the board in seeking solutions and corrective actions.

B. Risk related functions

2.1. How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

Especially for large international banks, the role of the chief risk officer has become of vital importance due to the risk management process turning into one of the main governance aspects of the financial institution.
What is important is that the chief risk officer function is distinct from other executive functions and is invested with sufficient authority, stature, independence, resources and access to the board. The equivalence with the chief financial officer role is relative to the organisation and complexity of each institution, however, for large complex ones they could be considered of comparable status.

2.2. How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

Effective risk management calls for proper communication, both horizontally across the organisation and vertically, up the management chain, done with a certain frequency. Procedures for referring problems in risk management should be part of a broader "risk culture", by which senior management and staff are in fact encouraged to identify and communicate these.
Responsibility for the "risk culture" is in the hands of boards and senior management.
The chief risk officer is considered "control function" staff. It is important to preserve the independence of staff engaged risk control staff. One way in which this is achieved is to ensure that the compensation structure of control function personnel does not compromise their independence or create conflicts of interest. The board of directors should also actively engage in control function personnel performance reviews.

Reference: Basel Committee for Banking Supervision, "Compensation Principles and Standards Assessment Methodology", 2010.

2.4. Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

The quality of risk monitoring of reporting is enhanced by appropriate controls, which entail appropriate technology; where necessary, this needs to be upgraded.

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

References:
- Basel Committee for Banking Supervision, "Framework for Internal Control Systems in Banking Organisations", 1998.
- For practical cases dealing with risk management problems, see UK House of Commons, Treasury Committee, "Banking Crisis: dealing with the failure of the UK banks", Seventh Report of Session 2008-09.

C. External auditors

3.1. Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

3.3. Should external auditors' control be extended to risk-related financial information?

Reference: Paolo Giudici, "Auditors' Multi-Layered Liability Regime", ECGI Law Working Paper 155/2010.

D. Supervisory authorities

4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?

4.2. Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?

The role of supervisors is to ensure that banks adopt good corporate governance, which is the responsibility of boards and senior management. This is done by on-site and off-site monitoring and regular communication with the board and senior management of the financial institution.

They should, however, take into account that institution's approach to corporate governance is proportionate with its structure and risk profile.
Should the functioning of the board and risk management function claim deficiencies, the supervisors would intervene through requiring remedial action.

References:
- For an examination of the new supervisory architecture in Europe, see Guido Ferrarini and Filippo Chiodini, "Regulating Multinational Banks in Europe: An Assessment of the New Supervisory Framework", ECGI Law Working Paper 158, 2010.
- For the role of regulation and supervision in the remuneration process of financial institutions, see:
Guido Ferrarini and Maria Cristina Ungureanu, "Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks", ECGI Law Working Paper 169, 2010.

4.3. Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

Yes. This can be achieved through two main channels. First, the licensing authority in the country where the institution is incorporated must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process includes the assessment of the fitness and propriety of board members. Furthermore, supervisors should also have the ability to assess the fitness and propriety of board members.

However the "duty of care" and "duty of loyalty" are essential in the approach taken by the board members. This fundamentally entails acting in the interest of the company, its shareholders and stakeholders.

References:
- Basel Committee for Banking Supervision, "Core Principles of Effective Banking Supervision" and "Core Principles Methodology", October 2006.
- For the "duty of care" and "duty of loyalty" see:
  - OECD, "Experiences from the Regional Corporate Governance Roundtables", 2003.
  - Jonathan Macey and Maureen O'Hara, "The Corporate Governance of Banks", Economic and Policy Review, 2003.

5. Shareholders

5.4. Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

Boards should make available more communication channels regarding governance matters, including board's role in risk oversight. In this way, boards can clearly

explain such procedures to investors, and also invite them to express views and concerns regarding strategy, governance and risk oversight.
Shareholders should have a voice particularly in approving pay policies which, however, should be of non-binding nature.
Proper disclosure (financial reporting in general) is what contributes to effective communication. Of particular importance is the disclosure of remuneration.

Reference: For the benefits of disclosure of remuneration see
Guido Ferrarini, Niamh Moloney and Maria Cristina Ungureanu, "Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe", Journal of Corporate Law Studies 10(1), 2010, pp. 73-118.

6. Effective implementation of corporate governance principles

See Introductory note.

7. Remuneration

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

"Variable remuneration" – is this referring to annual cash or annual cash and deferred and share-based payment?
If the institution is in such a difficult financial situation that the government had to intervene, and if it is using proper performance evaluation, the negative financial indicators may reflect unjustified variable remuneration. The payment or non-payment of variable remuneration should, however, consider the situation of individual banks, with particular care in situation where the restructuring of the institution is undermined by unjustified pay cuts.

Reference: For an examination of remuneration processes at banks that were saved by the governments during the financial crisis, including case studies, see
Guido Ferrarini and Maria Cristina Ungureanu, "Executive pay at ailing banks and beyond: a European Perspective", Capital Markets Law Journal 5(2), 2010, pp.197-217.

8. Conflict of interests

8.1. What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?

8.2. Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various

financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?

References:

- Klaus Hopt, "Takeovers, Secrecy, and Conflicts of Interest: Problems for Boards and Banks", in J. Payne, ed., Takeovers in English and German Law, Oxford (Hart) 2002, p. 33-63, and (ECGI Law Working Paper 0003, 2002)
- There are various measures encompassed in remuneration principles that help prevent conflicts of interest and the approach taken by supervisors in order to reinforce independence.
See: Basel Committee for Banking Supervision, "Compensation Principles and Standards Assessment Methodology", 2010.

Additional references (general aspects on corporate governance in financial institutions):
- Basel Committee for Banking Supervision, "Principles for Enhancing Corporate Governance", 2010.
- UK House of Commons, Treasury Committee, "Banking Crisis: Reforming Corporate Governance and Pay in the City", 2009.

Thank you for considering our comments. Please do not hesitate to contact us if we can be of further assistance.

Respectfully submitted,

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