The Joint Forum
Bank for International Settlements
International Organisation of Securities Commissions
International Association of Insurance Supervisors

By email: baselcommittee@bis.org

28 March 2012

Dear Sir,

Re: Principles for the Supervision of Financial Conglomerates

The International Corporate Governance Network (hereafter, ICGN) is a global organization which is dedicated to furthering the cause of improved corporate governance practices worldwide. The ICGN currently numbers over 500 individual members, drawn from the ranks of institutional asset managers, pension funds, their advisors, and other financial intermediaries, in more than 50 countries. The total value of assets managed by the firms these individuals represent is currently approximately $18 trillion, of which a considerable proportion is invested in financial institutions.

We welcome the opportunity to comment on the Joint Forum's consultative paper on the supervision of financial conglomerates. We confine our comments to the issues of most relevance to ICGN members, and where we have most expertise to contribute to the Joint Forum's debates: corporate governance and risk management.

A role for shareholders

Good corporate governance is essential. This is especially true for financial institutions, as they are pillars of our economies. Failure, and even the risk of failure, of these organisations can have grave consequences for the economies of any country to which an institution is exposed. Society as a whole thus has some interest in the good governance of these financial institutions, and especially financial conglomerates because of their complexity. This is not least because of the complexity of ensuring effective risk management in such substantial organisations.

What is good governance? Broadly, as the OECD states in its principles of corporate governance[1]: corporate governance describes the processes, policies and laws that govern how a company or group is directed, administrated or controlled. It defines the set of relationships between a company's management, its board, its shareholders and other recognized stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the

[1] Compare: OECD Principles, p. 11. See also Joint Forum Principles, p. 17.

means of attaining those objectives and monitoring performance are determined. Or as the European Commission states:

> *"Corporate governance is traditionally defined as the system by which companies are directed and controlled and as a set of relationships between a company's management, its board, its shareholders and its other stakeholders."*[2]

While society as a whole has an interest in the good governance of financial institutions and perhaps especially financial conglomerates, there is a key question to be answered: what is the most appropriate mechanism for delivering that good governance. The ICGN would argue strongly that the most effective mechanism for delivering good governance is for shareholders to play their full role as owners of these businesses, holding their boards accountable and driving better decision-making over time. While regulators may seek to set and enforce minimum standards it is only the shareholders which are capable of seeking, and have the necessary incentive to seek, progress towards best practice and the highest possible standards of governance.

We would therefore caution the Joint Forum not to ignore, not indeed to crowd out, the role of shareholders in encouraging better corporate governance at financial institutions. If given space to act, shareholders can play a key role in pressing for enhanced governance structures and may be able to do so in ways which are more effective than regulators. It is sometimes said that shareholders were not effective in the run-up to the crisis, indeed some acted in counter-productive ways. There is some truth in this, but shareholders, like regulators, have learned many lessons from the crisis and are working actively to implement those lessons. We encourage the Joint Forum to build this role of shareholders into their proposals; where they believe that the relationship between financial conglomerates and their shareholders is not proving productive, perhaps they should seek to address any underlying reasons for this failure, and not simply seek to substitute themselves for the proper role of shareholders. This is important not least so that inactivity and failure to carry forward their roles appropriately, either by boards of directors or by shareholders, is not in effect excused by the substitutive role of the regulators.

We would thus welcome the Joint Forum giving active consideration to how the role of shareholders can be more actively integrated into their model of corporate governance.

Basic requirements

The starting point for any quality corporate governance for the financial sector must be that their boards undergo fit and proper tests. Tests should assess not only competence and capacity to fulfil their roles, but attention must also be paid to their integrity and suitability.[3] We believe that these tests should be performed on an ongoing basis (eg for example at least every 3 years). In order to provide the necessary challenge and debate from a range of perspectives, boards also need to be diverse, in terms of skills, backgrounds, geographical experience, gender and age. Regular refreshment of boards also ensures that there are new heads around the boardroom table, bringing fresh questions and challenge.

The board must also set and clearly articulate, internally and externally, the organisation's risk appetite. The group needs to set an overall risk budget for all

[2] Compare: EU Green Paper, p. 2.
[3] Compare: BIS Fit and Proper Principles, p .40.

elements of the conglomerate, and the larger entities within it also need to clearly articulate their approach to the use of that budget. The group must perform adequate oversight of its underlying entities to ensure they are exercising their freedoms with due control. A focus more on long-term performance than short-term opportunism will drive value for the group as a whole.

With regard to risk appetite, we believe it is necessary for financial institutions to know who their counterparties are and to know the structure of the businesses from their counterparties. It is explicitly necessary to have a clear understanding of the derivates used by counterparties.

Establishing risk appetite also means that financial institutions should run risk systems which show a manager which risks exist and how they evolve. The risk system should be complementary to having in place appropriate arrangements for capital and liquidity management.

Complexity requires greater transparency

It is a fundamental truism that for all parties, whether shareholders or other investors, supervisors, or stakeholders more generally, to interact appropriately with an entity, they need to have clear insight into the company. This includes all aspects of corporate governance, risk management, shareholder rights, board nomination and remuneration. Financial conglomerates, because of their complexity, must make additional disclosures in order for these parties to understand them fully and so to play their full roles in relation to the conglomerate.

Without appropriate regulatory intervention to require and enforce transparency of conglomerates, it is too easy for such complex bodies to hide or withhold information. Thus it is necessary for regulators to set and enforce high hurdles of information provision for financial conglomerates, both in relation to the group as a whole and also with regard to the individual arms where these are of significant scale in their own right.

Part of the complexity in financial conglomerates may arise as the organisational structure of a financial institution can sometimes differ from its legal structure. Shareholders, but also managers, need to have clear insight into the legal structure. We note that the differences between the organisational and legal structures can sometimes lead to the existence of conflicts of interest. There is also the issue of conglomerates including regulated and unregulated entities, as well as entities regulated by different regulators. There is a crucial role for regulators in ensuring that this complexity does not allow issues to drop between the cracks of regulation, and to enable sufficient transparency such that the shareholder role can be effectively played in relation to the unregulated entities in particular – where there can be no substitution by the regulator for this role. A corporate governance framework should make sure that both regulated and unregulated businesses are lead by the same ethical and management standards.

Quality standards also need to be set and enforced. Shareholders and others need to be able to trust the financial statements provided by financial institutions. Statements made by board members should also clearly be true and accurate.

Conflicts of interest

One area where transparency is needed in particular is in respect of conflicts of interest. Conflicts will arise almost inevitably within financial conglomerates, and transparency and honesty about such conflicts will be a major way to address these issues. Furthermore, better standards of corporate governance will also help to mitigate conflicts of interest within such groups.

Shareholders need to have confidence that board members and executives take forward the company, not focusing on their own material gains, but in the interest of the group as a whole. A good corporate governance framework should provide safeguards which prevent conflicts of interest meaning that bad incentives play a role in decision-making. The board has a particular role to play in this regard, by considering long-term factors such as reputation and positive client relationships which the shorter-term perspectives of certain executives might otherwise undervalue, leading to poor management of conflicts situations – which might be perceived to generate value for the group in the short-term while the long-term damage is ignored.

We would thus encourage the Joint Forum to add a further principle specifically on conflicts of interest and the role of the group board in overseeing the associated risks, in particular where conflicts of interest arise between the different elements of a financial conglomerate. The aim of such policies on conflicts of interest must be to protect the interests of the clients of the financial conglomerate and to preserve long-term value in the group as a whole.

Remuneration

Remuneration is a key element of maintaining an appropriate culture within any financial institution. Having appropriate remuneration structures in place will help in addressing some of the issues highlighted above, not least in relation to client interests and conflicts of interest. We thus welcome the presence of a principle in the Joint Forum's proposed standards with regard to remuneration.

After all, the events of the past few years have demonstrated very clearly that remuneration (and annual bonus payments especially) can, if structured inappropriately, be an incentive for taking high risk decisions or even ones which in retrospect are clearly 'wrong', not least because they are too short-term in outlook. As the OECD Steering Group on Corporate Governance has stated, an explicit governance process needs to be established that will also define the role and duties of compensation consultants who are increasingly important. Good practice is for the process, remuneration structure and performance to be made transparent through some form of remuneration report. There also needs to be a possibility for shareholders to express their views about remuneration policy and even more direct influence on yearly remuneration packages.[4]

We find that compensation should be linked to the long-term interests of the company. We favour multi-year performance-based conditions, deferred compensation, and claw-backs.[5] We particularly welcome the call in the principle and its elucidation in the implementation guidance of the need properly to integrate risk analysis into remuneration framework. However, we are not sure that this articulation goes far enough: stating that pay should be aligned with prudent risk-taking only goes so far and we would argue that a further step ought to be taken in the implementation criteria such that it clearly states that a risk analysis needs to be integrated into any assessment of performance on which remuneration awards are based. One further element of best practice remuneration structures which we believe should be mentioned in the Joint Forum's discussion of this issue is that the

[4] Compare: OECD Corporate Governance Paper, p. 11.
[5] Compare: OECD Corporate Governance Paper, p, 10.

cost of capital associated with a particular activity needs to be integrated into the calculation of any rewards for those participating in this activity.

Risk Management

We believe that the Joint Forum should make two additions to its principles and implementation criteria in relation to risk management.

The first addition would fall under the principle regarding the culture of risk management (principle 22). The current principle and implementation criteria focus entirely on processes and procedures, which we believe is necessary but not sufficient to deliver an appropriate culture. We believe that a criterion should be added requiring that financial conglomerates have a relevant degree of expertise, both inside the organisation and among any independent advisers on risk, such that it has the competence to deal with the key issues.

The second proposal is with regard to principle 24, which focuses on new business. While this is appropriate as far as it goes, in requiring a robust risk assessment before entering any new business area, our discussions with the board members and former board members of financial institutions which failed in the crisis indicate that it is not enough. These individuals make clear that there is also a need to step back occasionally and to assess whether it is appropriate from a risk perspective to persist in existing businesses. The business environment may have changed (whether generally or in relation to a particular operation or activity), or the context may be different in other ways; it is necessary for the group board to assess on a regular basis whether the risk assessment means it is the right thing to continue with an existing business area. Just as the current principle articulates for new business, we believe that supervisors should require this robust regular assessment of whether the risk and business context has changed to make existing businesses no longer as attractive or appropriate to continue with.

Resolution plans

Finally, we would argue that the Joint Forum's proposals need to provide for the creation of resolution plans, in case bank recovery should ever become necessary. There need to be arrangements in place to deal with the failure of a financial institution, something that is of particular importance in relation to financial conglomerates. We believe that such a principle and implementation criteria could modelled on the proposals in the European Commission's Green Paper on Corporate Governance in Financial Institutions:

> *"Credit institutions should draw up and maintain recovery plans, setting out the arrangements that the credit institution has in place or the measures that it would adopt to enable it to take early action to restore its long term viability in the event of a material deterioration of its financial situation."*[6]

And these plans should, at least, include:

1. *arrangements and measures to restore the credit institution's own funds;*
2. *arrangements and measures to ensure that the credit institution has adequate access to liquidity to ensure that it can carry on its operations and meet its obligations as they fall due;*

[6] Consultation Paper on bank resolution, p. 19.

3. *arrangements and measures to reduce risk and leverage;*
4. *preparatory arrangements to facilitate the sale of assets or business lines in a time frame appropriate for the restoration of financial soundness;*
5. *where applicable, arrangements for possible intra-group financial support adopted in accordance with any voluntary agreement for group financial support; and*
6. *other management actions or strategies to restore financial soundness and the anticipated financial effect of those actions or strategies.*[7]

Furthermore, a resolution plan should:

1. *set out options for applying the resolution tools to the credit institution in a range of conceivable scenarios, including circumstances of systemic instability;*
2. *identify critical functions, and the necessary support functions, the sudden withdrawal of which would cause wider financial instability, and set out options for ensuring their continuity on the failure of the credit institution;*
3. *identify preparatory measures, including the legal and economic separation of critical functions, that are necessary to facilitate timely and effective action to ensure their continuity on the failure of the credit institution;*
4. *identify and, where relevant, compile the information that will be necessary for the resolution authorities to apply the resolution tools and exercise the resolution powers to implement those options in a timely and effective manner if the credit institution meets the conditions for resolution;*
5. *identify how the resolution options would be financed. The plan shall not assume extraordinary public financial support.*[8]

[7] Consultation Paper on bank resolution, p. 19.
[8] Consultation Paper on bank resolution, p. 31.

We would be delighted to discuss any aspect of this response if that would be of assistance to you. Please do not hesitate to contact ICGN Executive Director, Carl Rosen, at +44 207 612 7084 or by e-mail at carl.rosen@icgn.org.

Yours sincerely,

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