9 January 2015

ICGN submission on the Basel Committee on Banking Supervision Consultative Document: Corporate Governance Principles for Banks

To the Basel Committee:

The International Corporate Governance Network (ICGN) is pleased to respond to the Basel Committee on Banking Supervision Consultative Document: Corporate Governance Principles for Banks. The ICGN is an investor-led network, established 20 years ago, and we have 650 members based in 50 countries, including investors responsible for assets under management in excess of $US 18 trillion. Our mission is to inspire and promote effective standards of governance to support the sustainable long-term success of companies and to advance efficient markets world-wide. We do this by connecting governance professionals at global meetings, informing debate on emerging issues, influencing the development of good governance policy and fostering better engagement between companies and investors.

Overview

The banking sector is of fundamental importance to ICGN and its members. It is clear that governance shortcomings in the sector contributed to the recent global financial crisis in a way that had a hugely adverse impact not only on investors, but also on governments, taxpayers and society more generally. Even in the aftermath of the crisis, troubling issues of bank conduct, values and culture continue to surface and blight the sector and its reputation. The sector remains under great scrutiny—not only by regulators and supervisors-- but also by investors and broader stakeholders. In this context we welcome the Basel Committee's consultative document on best governance practices for banks.

It is important to stress that as an investor body we have interests in good bank governance from a range of perspectives. At the micro level, institutional investors hold equity and debt securities in individual banks. As shareholders, investors want banks to generate adequate returns to cover their cost of capital. As creditors, investors want to ensure that banks are well-governed to ensure that debt contracts are honoured and that creditworthiness is maintained. Inability to achieve these objectives will make banks unattractive as an investment holding.

It is also important to stress the macro/systemic dimension. Institutional investors tend to have much more direct exposure to non-bank institutions (including both companies and governments) than they do to banks themselves. In this context investors recognise that a healthy banking system is essential to provide debt capital to both the corporate and the public sector, as well as provide critical financial services to retail customers and small businesses. When banks function in a healthy way, this in turn, can contribute to a healthy economy that supports the interests of investors. But when an individual bank, or the banking system as a whole, experiences problems the ability of banks to support economies in a systemic context can become compromised, and this can have a larger knock-on effect on a wide range of financial and non-financial stakeholders, and society more broadly. Institutional investors, particularly those with long-term investment mandates, appreciate the importance of this systemic perspective, as well as the more immediate effect that good or bad bank governance might have on individual holdings of bank securities.

Comments on the consultative document

On the whole we believe the Principles as outlined in the consultative document are sensible, and we are broadly supportive of the written text as presented. However we believe that it is important to highlight important aspects of bank governance where this document is virtually silent or where greater focus may be required. Accordingly our comments focus on three main themes.

1. Role of investors in bank governance

The Principles as presented place appropriate emphasis on risk management and risk governance, and stress in particular the important role of bank supervision. While we think these issues are entirely relevant for consideration, we believe that the role of investors, shareholders in particular, is insufficiently stressed. The Principles do make reference to shareholder rights and the importance of responsible engagement in Point 17 of the Introduction. But there is limited, if any, elaboration on these points as a matter of bank governance.

A healthy banking system is one that is able to attract both equity and debt finance from institutional investors. Accordingly, it is important for both senior management and bank non-executive directors to understand investor needs and to engage with investors to generate mutual understanding and to address legitimate investor concerns. These can relate to many aspects of governance, including strategy, risk management, culture and ethics, auditing practices and remuneration. We recognise that bank supervisors have a critical role to play in overseeing these issues from a systemic perspective, but this cannot be to the exclusion of banks also maintaining a robust dialogue with holders of both bank equity and bank debt.

The Basel Committee will be aware of the ongoing development of stewardship codes in many markets globally. Such codes promulgate not only the rights of shareholders, but also their responsibilities as fiduciary agents on behalf of their beneficiaries. Investor responsibilities include the need to monitor investee companies, which include banks, to use voting rights in a considered way, and to engage with companies—particularly in areas that may present concern from an investment perspective. We believe that the guidelines outlined in the consultative document would be stronger if these points were recognised more explicitly. Perhaps the Basel Committee might therefore wish to elaborate on how the role of banking supervision might be complemented with more robust investor interaction.

We also think there is an opportunity in this document for the Committee to outline concerns as to what might best constitute "responsible engagement", as referenced in Point 17. For example, the Principles could be expanded to encourage investors to promote sustainable long-term commercial success for banks – both as a matter of systemic stability and attractiveness as a driver of positive investment performance. This might also lead to discouraging investor interventions that might encourage in potentially short-term outcomes or risky behaviours.

For example, while many investors may still encourage banks to focus on generating short-term returns on equity, a longer term perspective by investors might place less emphasis on a metric of this nature, which runs the risk of incentivising imprudent strategies that could weaken a bank's solvency. We believe therefore that an emphasis on a short-term return-on-equity metric should be discouraged. While banks should be expected by investors to generate returns over time that cover the cost of both debt and equity capital, investors should also be encouraging banks to promote systemic stability – which in turn should ultimately lead to lower risk profiles and lower costs of capital. Using the language of modern finance theory, this would suggest that investors should be actively encouraging prudent behaviour-- to reduce systematic risk (or "beta"), rather than seek to generate excess returns on equity -- "alpha"-- through their equity holdings in banks.

2. Remuneration

Given the rising trend of a shareholder vote on remuneration in many markets, the Principles here might benefit from a more explicit discussion of what types of metrics relating to incentive plans should be encouraged—or avoided-- from a systemic perspective. As noted above we would discourage the use of return on equity metrics as a basis for short-term incentive awards, and would rather encourage banks to incentivise covering the cost of risk adjusted capital. While the Committee may not wish to be overly granular in its consideration of remuneration issues, we note that the guidelines are silent on the issue of quantum (absolute level of remuneration). Absolute levels of bank pay and bonuses, not only at the executive management level, but throughout banking organisations, present risks of an unjustified imbalance between payments to staff versus capital retention and the need to provide dividends to shareholders. This is also an area under increasing scrutiny by civil society, particularly for banks and boards that are unable to provide a compelling explanation of absolute pay levels. This should be a matter of concern both for investors and bank supervisors.

We also believe it may be productive for institutional investors and bank regulators to meet on occasion for the purpose of reinforcing areas of mutual interest, as well as identifying issues where there may be divided opinions. The ICGN would welcome an opportunity to facilitate such a discussion with the Basel Committee or other regulators.

3. Conduct, culture and ethics

We note positively that issues relating to conduct, culture and ethics are referred to in several parts of the draft Principles. We believe this is highly appropriate insofar as many of the underlying causes of both past and current bad practices relate to weak cultures, ethics and values. Not only can breaches result in increasingly large fines and reputational damage, they can also contribute to further structural weakening of the banking sector.

We agree that the draft Principles should identify an ethics committee as one possible way for a board to address these risks, but also agree that this should not be presented as a prescriptive requirement. Nevertheless, even without a dedicated ethics committee, it is incumbent on both boards and top management of banks to pay serious attention to the variety of ways that bank activities impact with broader society, and to take all necessary measures to "futureproof" banks from social, ethical and environmental risks that may have been less obvious areas of focus in prior generations. These issues must be recognised not only in the ethical dimension, or in a corporate social responsibility context, but as real drivers of risk and opportunity that relevance for investors and in a broader systemic context.

We agree with the language in the guidance encouraging the "soft", but very real, risks relating to conduct, culture and ethics to be captured in compliance oversight and risk management. While these qualitative factors are often difficult to quantify, both investors and bank supervisors should hold to account management and boards to provide the right tone and cultural values and to ensure that these factors are rigorously included in systems relating to enterprise risk management.

We hope you find these comments useful for your deliberations, and would be pleased to elaborate further.

Yours faithfully,

Erik Breen
Chairman, ICGN Board of Governors

George Dallas
Policy Director, ICGN

ICGN contacts:
George Dallas, Policy Director: george.dallas@icgn.org
Kerrie Waring, Managing Director: kerrie.waring@icgn.org