ICGN Statement on Systemic Disruption in the Global Banking Industry

23rd March 2023

The world's financial system has once again failed to properly assess material risks accruing from the banking industry to protect depositors, investors, and the businesses they serve. At least two banks in the United States have failed, resulting in bailouts and potential losses in excess of $3 billion in the last month. Global banks are now seeking assurance that they too will be rescued, with at least one takeover of a bank by another, wiping out the investments of shareholders in the acquired bank. Stock markets have entered extremely choppy waters. The turmoil results from a situation that football fans say resembles an 'own goal': bad judgement and mis-positioning that leads to a player scoring against their own team.

The effectiveness of corporate governance and the ability of investors to hold boards to account on behalf of the investing public is once again under scrutiny. This latest debacle demonstrates that boards that have weak corporate governance controls and limited oversight are ineffective in holding management accountable for poor capital allocation strategies, human capital management, and the evaluation of social and economic risk factors to the detriment of investors and wider society. In short, such failures demonstrate that a lack of good corporate governance ultimately impacts long-term corporate value, upon which we all rely.

The International Corporate Governance Network (ICGN), since its founding in 1995, has been a leading voice for the highest standards of corporate governance and investor stewardship world-wide. This is articulated in the ICGN Global Governance Principles (ICGN Principles), which clarify an investor perspective on pillars which are the foundations of effective corporate direction and control, such as fairness, accountability, responsibility, and transparency, thus helping boards effectively manage systemic risks and support sustainable business practices. Importantly, ICGN Members - who today collectively manage around $70 trillion in assets - use the ICGN Principles in their voting polices and company engagements and governments often refer to them when reviewing national frameworks.

Sadly, the warning signs related to the latest collapse have been in evidence and include:

- Commercial decisions that align with the short-term tenure of management and the requests of short-term investors, but at the expense of long-term corporate viability.
- Sell outs of stock by key executives, share buybacks, large executive compensation packages lacking clear ties to risk assessments and long-term performance, and limited or no clawback policies for ill-gotten executive gains.

- Limited oversight by regulatory authorities for speculative deals beyond the public markets, investment strategies with excessive leverage and reporting requirements on material and non-material financial risks.

- Financial disclosures and public statements that do not match the reality of the short and long-term losses that were not disclosed or hidden in financial records.

Global regulators are once again calling for greater oversight of banking institutions and executives to address inadequacies to curtail risky behaviour that negatively impacts the global financial system. And whilst the increase in interest rates by the Federal Reserve and other regulated markets have contributed towards this recent bank failure, a more fundamental cause of the disarray is hubris on behalf of bank executives and wishful thinking by the corporate boards that oversee them. Essentially this amounts to a situation where strong returns on financial stocks led to confidence that the internal controls risk management requirements implemented after the 2008 Global Financial Crisis were no longer necessary. A continual rollback of regulations and diminished oversight has allowed smaller banks to avoid the corporate "burden" of performing stress tests to be disclosed in regulatory filings.

Going forward, ICGN is calling again for a global economic and financial structure that serves investors, businesses, the economy, and wider society. Specifically, we call for:

1. **Stronger corporate governance practices to be adopted by boards as clarified in the ICGN Principles.** Boards must focus on their fiduciary duties to shareholders and relevant stakeholders for preserving and enhancing sustainable value over the long-term including oversight of risk assessment, management, and mitigation.[1]

2. **Boards of directors must identify and analyse the known and potential risks that cut across their lending portfolios, capital allocation strategies, leverage position and commitments.** Such risks have the potential to create perverse incentive structures for executive compensation. As noted in the ICGN Principles, performance measures in incentive-based plans should integrate risk considerations so that there are no rewards for taking inappropriate risks at the expense of the company, shareholders, and stakeholders. Companies should include provisions in their incentive plans that enable the company to withhold the payment of any sum ('malus'), or recover sums paid ('clawback'), in the event of serious misconduct or a material misstatement in the company's financial statements.[2]

3. **Assertive action should be taken to reform the weaknesses in regulatory and legislative oversight**, including reporting requirements for stress testing and the re-establishment of risk and oversight committees for smaller and regional financial institutions, and higher capital requirements with more robust leverage ratios. Whilst ultimate responsibility for a company's risk management approach rests with the full board, having a risk committee can be an effective mechanism to bring the transparency, focus and independent judgement needed to oversee the company's approach to risk management and internal controls. A risk committee, and the board more generally,

[1] ICGN Global Governance Principles, 2021, pp. 8-9.
[2] ICGN Global Governance Principles,2021, p. 21.

should be informed through the company's enterprise-wide internal control and risk management system.[3]

4. **Regulators should initiate enforcement actions to uncover sales of stock, excessive compensation paid out to executives prior to collapse and require that any ill-gotten gains be returned to investors**. Regulators must have the information necessary to determine whether the reported financial disclosures and a company's public statements match or may have misled investors.

In conclusion it is appropriate to also consider the effectiveness of investors in holding companies to account, and in this case the more recent failures in the banking industry. Investors provide capital for long-term value creation and as such, must be afforded robust shareholder rights as legitimate owners. In particular, the equitable treatment of investors is essential. When failing companies become the targets of acquisitions, investors with holdings in both the target company and the acquiring company should be provided the right to vote to approve such takeovers or vote against them as part of their fiduciary duties. Moreover, investor confidence is necessary to instill support for revised business continuity plans in the face of this crisis. The lessons here for investors again are hard learned. Reliance on external ratings and rankings, without internal oversight and due diligence, can lead to a false sense of security. This therefore requires investors themselves to incorporate a greater review of governance, including the effectiveness of board decision-making and composition, into their wider due diligence approach to stewardship.

[3] ICGN Global Governance Principles, 2021, p. 25. See also ICGN Guidance on Corporate Risk Oversight, 3rd Edition, 2015; ICGN Viewpoint on Corporate Risk Oversight Committee view on obstacles and questions in risk oversight, May 2014.