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Changing the agenda – The role of corporate governance and risk management in financial regulatory reform

As regulators and policymakers continue their efforts to find the best way to prevent a repetition of the financial crisis that almost engulfed the world economy, re-evaluating how corporate governance and risk management can make the financial system more secure has become a crucial question. Clifford Chance organised three round-table debates between 2009-2010 to assess this issue. With financial regulatory reform continuing to dominate the global political agenda, Clifford Chance has decided to publish a summary of these discussions as part of its commitment to promoting a balanced and informed analysis of the challenges that lie ahead.

Much has been written and spoken about the causes of the financial crisis. Most people accept it is time to learn the lessons and move on.

While the need to reform the banking and the financial services sector is beyond question, there is a tension between the desire to 'get it right' and the intense pressure for politicians and regulators to act quickly and decisively. In the ensuing debate over regulation and reform, the real issues of corporate governance and risk management have been largely obscured by the remuneration question. "There are some conflicting imperatives," said Michael Bray, a partner in Clifford Chance's London office. "We still have a long way to go."

Among a host of challenges facing the global financial community are questions of its own reputation, harmonizing rules of conduct and regulation, and myriad issues surrounding individual and corporate behaviour and culture.

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At the heart of it is risk: understanding it, managing it and challenging those whose job it is to make sure risk and risk-takers are under control. It is clear that a 'collective intellectual failure' in understanding and managing risk contributed to the financial crisis alongside various other issues of regulation and corporate governance.

Collective remedial action has been slow in coming, according to Daniela Weber-Rey, a partner in Clifford Chance's Frankfurt office. But the debate is shifting and Daniela believes that there is a recognition that regulation alone cannot bring about the necessary change. "What is needed is a cultural change. And its successful integration into business life is the ultimate challenge," she said.

However, while the pace of reform is quickening and an ever increasing body of new regulation is being proposed by policymakers and regulators across Europe, the opportunity for a dispassionate analysis of the real issues that need to be understood and addressed as part of any meaningful reform of the financial services sector lags behind.

Despite the introduction of substantial reforms during the past few months such as the Dodd-Frank Act in the USA, international agreement on Basel III requirements, and various changes to the financial architecture in Europe, governments and regulators have not been able to establish a truly level playing field. Good original intentions are sometimes followed by incoherent regulation. In some cases, even if the regulation is the same for a group of companies, its implementation and enforcement is by no means certain to be the same. The challenges are still out there. The risk of long-term damage to banks and other financial institutions – and ultimately to the global economy – posed by this fragmented and sometimes misdirected approach or its inconsistent application is great. The tension between providing appropriate regulation in reaction to the financial crisis and creating a level playing field between the EU Member States and in particular between the EU on the one side and the US and Asian financial markets on the other side presents a major challenge.

Clifford Chance has long recognised the need for a wide-ranging, pan-European and informed debate that goes beyond the usual channels of legal policy matters. As part of its efforts to address this issue, Clifford Chance organised a series of round tables between December 2009 and June 2010 in Frankfurt, London and Zurich to discuss the role of corporate governance and risk management in the reform of the financial sector. These meetings brought together senior practitioners including CEOs from major international banks, chief risk officers (CROs), non-executive directors (NEDs), macro-economists and regulators to analyse the crucial issues and to share their insights.

Although much has happened since these round tables were held, the real challenge facing policymakers and regulators has not changed. Even though the publication of the EU Commission Green Paper on corporate governance in financial institutions and remuneration policies in June 2010 and the subsequent consultation has laid the ground, the issues highlighted in Clifford Chance's round tables remain crucially important in 2011.

Clifford Chance has therefore decided to publish a summary of the main points from these debates as part of the firm's continuing commitment to promoting a balanced debate on the reform of the financial sector.

The crisis: what went wrong

Throughout the series of round tables, speakers observed that mismanagement lay at the heart of the banking crisis. As the Turner Report into global banking regulation put it, competence, not organisation or structure, was the issue. One speaker, Stilpon Nestor, managing director of Nestor Advisors Ltd of London, took that message further with research that pointed to weak boards of directors. Many bank boards, he said, suffered a collective crisis of competence. Many simply failed to recognise the signs of trouble, let alone deal with them.

Other speakers pointed out the flaws in theories such as market self-regulation, light-touch and principles-based regulation and the capital asset pricing model (CAPM). Before the financial crisis few people understood the implications of a global economy that lacked its own safety net.

Risk management emerged as one of the main themes post crisis and was intensely debated at the round tables. As one speaker noted, risk is clearly at the heart of any financial institution and there are no silver bullets in managing risk. Risk governance structures alone are not a substitute for a strong risk culture within an institution. Daniela highlighted that a strong risk culture requires "the tone to be set from the top". The model of independent risk assessment, outlined in Basel II, predated the crisis, but its implementation through risk committees was slow. Similarly, audit committees spent much more time pre-crisis on compliance issues than on fundamental risk in the balance sheet.

Innovation in global capital markets since the Financial Services Action Plan was so quick and so complex that the true systemic risks were not fully understood. It would have also been politically untenable for anyone – regulator or policymaker – to have tried to intervene during an era when, on the face of it, light touch regulation appeared to be working successfully.

Impact of the crisis

The crisis highlighted numerous flaws, among them the flaw in the pan-European financial system. The global system was saved by national economies which has led inevitably to stronger national political influence.

The financial crisis also damaged the relationship between the banks and the public. Public sentiment hit boiling point. Confidence in the banking sector hit rock-bottom. Even today, the public remains deeply sceptical about the value and role of banks in supporting economic growth.

The need to restore the public's trust and to improve the reputation of banks was one of the points to emerge from the discussions at the round tables.

Theodor Weimer, CEO of HVB Group, the German subgroup of Unicredit, highlighted the need for banks to focus on cultural change as part of their efforts to improve their reputation.

Other speakers highlighted the dangers in the politicisation of the debate. Rushing through momentous changes to meet political timetables is a recipe for later problems. Politicians and financial authorities risked losing sight of the fact that reform still has to meet the principles of good regulation and regulation is only as good as its implementation and enforcement.

Looking backward to prevent a recurrence of the last crisis does not help in meeting the challenges ahead. "There's a danger of that leading to over-regulation and not taking us to where we need to be," said Michael Bray.

Shape of the post-crisis financial sector

Banks coming out of crisis have the difficult challenge of demonstrating that things have actually changed.

Much of it boils down to corporate culture, itself an elusive concept. Banks have already started changing their cultures. A return to enterprise-wide risk management is a common theme. More time is being put into economic capital modeling and stress tests that go way beyond many of the things sought by regulators.

One speaker explained that changing behaviour alone was not sufficient and that there was a need to ensure that suitable processes were also put in place to support it. The speaker cited the example of the UK's approach which defined governance as a combination of enterprise risk management, a consistent framework and the controls in place around it, as well as the actual governance and structure of the group.

Over-familiarity between executive and non-executive directors, a byproduct of long association, can blunt the capacity to challenge. The non-executive director role is changing. The role demands a considerable investment of time and skill. NED independence is important, but competence must be the absolute priority, said Daniela Weber-Rey.

Greater demands on NEDs in their governance role means more time must be devoted to the job, said Laurie Adams, managing director of Outside Insight and a NED of Northern Rock. Finding people who are prepared to put in the time must now be added to the other qualities sought in prospective directors.

Among the other views that emerged from the debates was the need for NEDs to be more proactive, although admittedly it is difficult for NEDs to challenge a successful management team. The experience of Australia, one of the countries that emerged relatively unscathed from the financial crisis, suggests that screening all prospective board members to see if they are capable of making decisions on behalf of that bank is sound policy.

As for shareholders, they also have responsibilities. It is one thing to encourage them to be active, but some institutional investors may have 500 companies in their portfolio, making it virtually impossible to play a role in relation to each one. Shareholders investing solely in the indices do not take part in an individual company's corporate governance debate, raising doubts whether the shareholder can control the company and hold the management accountable. The EU Commission is, however, absolutely determined to see to it that shareholders will in future be able to prevent financial institutions from taking too much risk and will be asked to exercise their power.

One issue that is continuing to preoccupy policymakers and regulators is remuneration. At the round tables the question of remuneration was acknowledged to be a tremendously difficult, symbolic issue that required dispassionate and objective debate rather than the emotional responses it has so far provoked.

Speakers expressed the fear of unintended consequences of hasty, uncoordinated and ill-thought moves by legislators around the world which threaten to create a disconnect between performance and pay. There is a risk of creating a profoundly unlevel playing field. The political will to drive such change must be matched by a level of uniformity and international consensus.

The emerging agenda

"It is clear that, from a risk perspective, boards will in future be asked to take a more active role in the design and objectives of stress testing", said David Pudge, a partner in Clifford Chance's London office. Increasingly, NEDs on bank boards will reflect a greater diversity of backgrounds, skills and experiences, with a greater emphasis on their capacity to challenge. In addition, NEDs will not only be required to have more financial expertise, they will be required to demonstrate it by undergoing in-depth induction and externally facilitated evaluations of director competence.

A greater focus on risk appetite is a likely development, as is a greater focus on group governance and structure, the latter driven by demands from regulators for more visibility on liquidity and capital adequacy.

Among proposed regulatory changes, those on capital requirements that are set out in Basel III will have the greatest impact. Capital has a very important function in stabilising the system but it is extremely expensive. Banks will respond by cost-cutting, repricing and deleveraging. The business mix will change, affecting profitability. Top line growth will be slower than any time in the last 20 years. The impact on financing economic growth will be considerable. Companies in Europe will increasingly have to turn to the capital markets for financing the economy, pushing Europe towards the US model. According to Daniela Weber-Rey, this consequence is "sadly not widely recognised and companies in Continental Europe in particular are not preparing sufficiently for this shift in financing of the economy".

Speakers agreed on the need for a common European approach to supervision. One step towards a common approach has already begun to be rolled out in 2011 with the introduction of a new structure of European supervisory authorities to replace the three Level 3 (3L3) committees for insurance, banks and financial markets.

Next steps

Strong risk management and governance starts with an understanding by boards of the nature of the risks their firm is taking, and a clear idea by directors of the level of risk that they are prepared to have within the business.

Speakers at the Clifford Chance round tables agreed that the capacity of CROs and NEDs to challenge the institution's management was critically important and should be developed. Equally, building a responsibility for risk into a bank's culture was clearly a step in the right direction.

Proper contingency planning for big, universal banks should ensure their recovery from a crisis while adequate resolution regimes will make it possible to wind down an operation gently to avoid creating the "tidal waves" seen when Lehman Brothers collapsed. Big banks need to consider at what point they become "too big to manage" and regulators are also focusing on this issue. This is reflected in boards looking into diversifying and spinning off parts of their business. However, the issue of the interconnectedness of the market would likely increase as an unintended consequence of breaking up big banks into smaller units.

It is important not to set regulators up to fail through a lack of resources, political backing or intellectual capacity. One speaker said that the answer might be to give regulators bigger budgets and to look at some of the structural issues that they faced.

Michael Bray agreed. “Regulation is only as good as the regulators we have. The challenge is to put in place a system with regulators who have the necessary quality to look for and see what is actually happening and who will intervene at the right level. But to get the right sort of people for the job, we are going to have to pay them appropriately and then train them in a different mindset,” he said.

Reflecting on the issues that had been debated at the three round tables, Michael said he had come to the conclusion that, if there had been a collective intellectual failure before the crisis to understand the systemic risks inherent in the financial system, those risks were now well understood by bankers. “There has been much activity within banks to overhaul risk management systems to give the chief risk officer the appropriate status and to enhance the role’s accountability to the board,” he said.

Michael added that banks were focused on the question of what might destroy them and were modifying their governance systems and implementing many of the recommendations in the Walker Report which looked at governance issues in the UK financial sector. “In time, these enhanced governance systems will lead to significant cultural change within banks which will surpass anything that can be brought about by the excessive and fragmented regulatory changes that politicians and regulators are seeking to impose,” he said.

In any event, it was considered unfortunate that excessive regulation developed at a time when a seismic shift in economic power from the West to the East can be witnessed, with no inclination on the part of the authorities in the East to match the regulatory output and control of the financial markets in a similar manner to their Western counterparts.

There seemed to be a collective acknowledgement during the round tables that we may be moving towards a period of dysfunctional and inefficient markets that make it even more difficult to sustain a return of the world economy to dynamic growth. This outlook makes it even more important to continue to seek risk control by way of a better regulation and improved board composition and competence while fighting for a level playing field at the same time.

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