TOWARD EFFECTIVE GOVERNANCE of FINANCIAL INSTITUTIONS
The views expressed in this report are those of the Working Group on Corporate Governance and do not necessarily represent the views of all individual members of the Group of Thirty.

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TOWARD EFFECTIVE GOVERNANCE of FINANCIAL INSTITUTIONS
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# ABBREVIATIONS

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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>CEO</td>
<td>chief executive officer</td>
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<td>CRO</td>
<td>chief risk officer</td>
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<td>FI</td>
<td>financial institution</td>
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<td>FSA</td>
<td>Financial Services Authority (UK)</td>
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<td>FSB</td>
<td>Financial Stability Board</td>
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<td>G30</td>
<td>Group of Thirty</td>
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<td>HR</td>
<td>human resources</td>
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<td>IT</td>
<td>information technology</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>SIFIs</td>
<td>systemically important financial institutions</td>
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Weak and ineffective governance of systemically important financial institutions (SIFIs) has been widely cited as an important contributory factor in the massive failure of financial sector decision-making that led to the global financial crisis. In the wake of the crisis, financial institution (FI) governance was too often revealed as a set of arrangements that approved risky strategies (which often produced unprecedented short-term profits and remuneration), was blind to the looming dangers on the balance sheet and in the global economy, and therefore failed to safeguard the FI, its customers and shareholders, and society at large. Management teams, boards of directors, regulators and supervisors, and shareholders all failed, in their respective roles, to prudently govern and oversee.

On the subject of governance as it applies to FIs, much has been written and said in the past few years. Notable among these statements are the 2009 Walker report (A Review of Corporate Governance in UK Banks and other Financial Industry Entities) and the Basel Committee’s Principles for Enhancing Corporate Governance (2010). Many domestic regulators and stock exchanges have also weighed in with new requirements and guidelines for governance. The Group of Thirty (G30) applauds these prior initiatives and supports not only the spirit of their conclusions but also many of the detailed recommendations they contain. The combination of these reports, self-scrutiny by the firms themselves, and pressure from regulatory overseers has already yielded substantial changes in governance practice across the financial services industry and around the globe.

Why would the G30 wish to add its own voice to the body of work already available, in light of progress being made?

♦ First, no one should presume that FI governance is now fixed. It is true that boards are working harder; supervisors are asking tough questions and preparing for more intensive oversight; management has become much more attuned to risk management and to supporting the oversight responsibilities of the board; and shareholders, to some degree, are taking a deeper look into their role in promoting effective governance. Nevertheless, as this report highlights, highly functional governance systems take significant time and sustained effort to establish and hone, and the G30’s input can help with that effort.

♦ Second, in a modern economy, business leadership represents a large concentration of power. The social externalities associated with the business of significant financial institutions give that power a major additional dimension and underscore the critical importance of good corporate governance of such entities.

♦ Third, we note that the prior reports and guidance almost always come from a national or regional perspective (the Basel Committee report being a notable exception), which is understandable as a practical matter, but curious given the distinctly global nature of the SIFIs, which are appropriately the focus of attention.

Accordingly, in late spring of 2011, the G30 launched a project on the governance of major
financial institutions. The project was led by a Steering Committee chaired by Roger W. Ferguson, Jr., with John G. Heimann, William R. Rhodes, and Sir David Walker as its vice-chairmen. They were supported by 11 other G30 members, who participated in an informal working group. Requests for interviews went out from the G30 to the chairs of 41 of the world’s largest, most complex financial institutions—banks, insurance companies, and securities firms. In an extraordinary response, especially in light of the pressures on each of these companies, 36 institutions shared their perspectives and experiences through detailed discussions with board leaders, CEOs, and selected senior management leaders. In addition, the project team held discussions with a global cross section of FI regulators and supervisors. The majority of these interviews were conducted in person, all under the Chatham House Rule, which encourages candor.

The report is the responsibility of the G30 Steering Committee and Working Group and reflects broad areas of agreement among the participating G30 members, who took part in their individual capacities. All G30 members (aside from those with current national official responsibilities) have had the opportunity to review and discuss preliminary drafts. The report does not reflect the official views of those in policy-making positions or leadership roles in the private sector.

The report is wide-ranging in its coverage of the composition and functioning of FI boards and the roles of regulators, supervisors, and shareholders. The focus is on potentially universal core themes but acknowledges differences in customs and practice in different parts of the world. As regards approaches to total compensation, we do not address this subject in detail in this report; the G30 commends the Financial Stability Board’s Principles for Sound Compensation Practices and fully supports their implementation.2

The G30 undertook its initiative on effective FI governance in the hope and expectation that FI board and senior management leaders could share actionable wisdom on the essence of effective governance and what it takes to build and nurture governance systems that work. We hope this report provides a measure of insight and sustenance to those with policymaking and operational responsibilities for effective governance in the world’s great financial institutions.

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1 The rule states that “When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.”

2 The complete list of principles can be found at http://www.financialstabilityboard.org/publications/r_090925c.pdf.
On behalf of the entire Group of Thirty (G30), we would like to express our appreciation to those whose time, talent, and energy have driven this project to successful fruition. First, we would like to thank the members of the Steering Committee and Working Group, who guided the work at every stage and added their unique insight.

Special recognition must go to the men and women of the financial, regulatory, and supervisory institutions whom we interviewed, who generously and candidly shared their perspectives and experiences and whose insight constitutes the heart of this report. Participating financial institutions have their headquarters in 16 different countries on six continents. From all points on the globe, these senior leaders strongly testify to the role effective governance can play in securing the safety, soundness, and performance of the global financial system.

No project of this magnitude can be accomplished without the committed effort of a strong team. The G30 extends its deep appreciation to Tapestry Networks; project director Tom Woodard; and team members Mark Watson, Dennis Andrade, and Christopher McDonnell. For this project, Tapestry Networks carried out the core research and drafted reports for review by the G30. They organized and conducted more than 80 interviews, the vast majority in person. In addition, the team drew on more than 70 additional interviews with directors, supervisors, regulators, and executives, conducted as part of Tapestry’s normal course of business. Tapestry’s work was conducted in collaboration with Ernst & Young LLP, under the leadership of Carmine DiSibio, vice-chair of global financial services; and William Schlich, global leader of banking and capital markets. The G30 is grateful for Ernst & Young’s vital support. The G30 also thanks the other colleagues from around the world who provided their informal feedback to the text as it developed.

Finally, the coordination of this project and many aspects of report production had their logistical center at the offices of the Group of Thirty. This project could not have been completed without the efforts of executive director Stuart Mackintosh, Meg Doherty, and Emily McGrath of the G30.

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* All the members participated in the project in their individual capacities. The views expressed do not necessarily reflect those of the institutions with which the members are affiliated.
What is meant by “governance” in the context of a financial institution (FI)? Corporate governance is traditionally defined as the system by which companies are directed and controlled. The OECD Principles of Corporate Governance (2004) defines corporate governance as involving

"a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."  

In the case of financial institutions, chief among the other stakeholders are supervisors and regulators charged with ensuring safety, soundness, and ethical operation of the financial system for the public good. They have a major stake in, and can make an important contribution to, effective governance.

Good corporate governance requires checks and balances on the power and rights accorded to shareholders, stakeholders, and society overall. Without checks, we see the behaviors that lead to disaster. But governance is not a fixed set of guidelines and procedures; rather, it is an ongoing process by which the choices and decisions of FIs are scrutinized, management and oversight are strengthened and streamlined, appropriate cultures are established and reinforced, and FI leaders are supported and assessed.

**WHY GOVERNANCE MATTERS**

The global economic crisis, with the financial services sector at its center, wreaked economic chaos and imposed enormous costs on society. The depth, breadth, speed, and impact of the crisis caught many FI management teams and boards of directors by surprise and stunned central banks, FI regulators, supervisors, and shareholders.

Enormous thought and debate has gone into discovering what caused the global financial crisis and how to avoid another. In his much-quoted 2009 report on the causes of the crisis, Lord Adair Turner, chair of the UK’s Financial Services Authority (FSA), cited seven proximate causes: (1) large, global macroeconomic imbalances; (2) an increase in commercial banks’ involvement in risky trading activities; (3) growth in securitized credit; (4) increased leverage; (5) failure of banks to manage financial risks; (6) inadequate capital buffers; and (7) a misplaced reliance on complex math and credit ratings in assessing risk. A critical subtext to these seven causes is a pervasive failure of governance at all levels.

More generally, most observers have agreed that a combination of “light touch” supervision, which relied too heavily on self-governance in financial firms, and weak corporate governance and risk management at many systemically important financial institutions (SIFIs) contributed to the
2008 meltdown in the United States. In several key markets, deregulation and market-based supervision were the political order of the day as countries vied for global capital flows, corporate headquarters, and exchange listings. Regulators also missed the potential systemic impact of entire classes of financial products, such as subprime mortgages, and in general failed to spot the large systemic risks that had been growing during the previous two decades.

In this context, boards of directors failed to grasp the risks their institutions had taken on. They did not understand their vulnerability to major shocks, or they failed to act with appropriate prudence. Management, whose decisions and actions determine the organization’s risk status, clearly failed to understand and control risks. In many cases, spurred on by shareholders, both management and the board focused on performance to the detriment of prudence.

Effective governance is a necessary complement to rules-based regulation. The system needs both. Carefully crafted rules-based regulations concerning capital, liquidity, permitted business activities, and so forth are essential safeguards for the financial system, while effective governance shapes, monitors, and controls what actually happens in FIs.

Ineffective governance at financial institutions was not the sole contributor to the global financial crisis, but it was often an accomplice in the context of massive macroeconomic vulnerability. Effective governance can make a significant positive difference by helping to prevent future crises or by mitigating their deleterious impact. In other words, the rewards for investment in effective governance are great.

**A CALL TO ACTION**

Each of the four participants in the governance system—boards of directors, management, supervisors, and (to an extent) long-term shareholders—needs to reassess their approach to FI governance and take meaningful steps to make governance stronger. This report offers a comprehensive set of concrete insights and recommendations for what each participant needs to do to make FI governance function more effectively.

The G30 is acutely aware that the agendas of FI boards and supervisors are crowded, yet we urge them to continue to give effective governance one of their highest priorities.

- The financial sector needs better methods of assessing governance and of cultivating the behaviors and approaches that make governance systems work well. Board self-evaluation, especially when facilitated or led by an outside expert, can yield important insight, but it is sobering to consider that in 2007, most boards would likely have given themselves passing grades.

- Supervisors now aspire to understand governance effectiveness and vulnerabilities, but admit to having much to learn.

- Governance experts often describe what good governance looks like, but give little thought to how to measure or achieve high-performance results.

Given the role that inadequate governance played in the massive failure of financial sector decision making that led to the global financial crisis, it is natural that supervisors and stock exchanges are now paying great attention to governance arrangements. This attention, as a practical matter, often focuses on explicit rules, structures, and processes—best practices—that governance experts often believe are indicative of effective governance. Consequently, compliance with best practice guidelines has become very important to boards and to overseers charged with monitoring and encouraging good governance.

The G30 hopes this report will contribute meaningfully to the body of knowledge on governance and will be a useful tool for those tasked with shaping governance systems.
THE ESSENTIAL QUESTION OF FUNCTION

Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.

Although the temptation to judge governance effectiveness by the extent of conformance to a set of perceived best practices can be overwhelming, it is also counterproductive. Most studies of governance agree that it is end behaviors, much more than frameworks and structures, that matter. “Box-ticking” neither improves governance nor accurately assesses it. Any arrangement can fail, but failures are more often caused by undesirable behavior and values than by bad structures and forms.

An examination of governance arrangements at 36 of the world’s largest FIs reveals a wide diversity of approaches, driven by differences in culture, law, institution-specific circumstances, the people involved, and precedent. This diversity is a good thing, since it means that the governance approaches are tailored to address the unique circumstances of each FI. Greater homogeneity would likely lead to poorer governance because the constraints that would have to be introduced to ensure homogeneity would reduce FIs’ freedom to optimize.

This suggests that all parties with a stake in the design, operation, and assessment of governance systems must concentrate on the essential question of function and let the issue of form recede.

Behavior appears to be key, and a focus on right behaviors means a shift from the “hardware” of governance (structures and processes) to the “software” (people, leadership skills, and values). This means asking questions such as: How does the board both engage and challenge management? How does it support management in overcoming key difficulties? Are interactions open and transparent? Does management help the board understand the real issues? What is the attitude of the CEO toward the board? Is the relationship between the CEO and the chair (where those roles are split) a constructive one? Are issues presented to the board in a way that is amenable to the application of business judgment? What underlying organizational culture and values drive behaviors—and how can a desired culture best be supported and reinforced?

The art of governance is in making different forms function well and adjusting the form to enhance function. It takes mature leadership, sound judgment, genuine teamwork, selfless values, and collaborative behaviors—all carefully shaped and nurtured over time.

THE BOARD

Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy; the assessment of risk taking; and the assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy.

The 2008–2009 financial crisis revealed that management at certain FIs, with the knowledge and approval of their boards, took decisions and actions that led to terrible outcomes for employees, customers, shareholders, and the wider economy. What should the boards have done differently? To answer that question, it is helpful to consider the mandate of boards.

Boards control the three key factors that ultimately determine the success of an FI: the choice of business model (strategy), the risk profile, and the choice of CEO—and by extension the quality of the top-management team. Boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk, and talent issues are making a critical mistake. Above all else, boards must take every step possible to protect against potentially fatal risks.

FI boards in every country must take a long-term view that encourages long-term value creation in the shareholders’ interests, elevates prudence without
diminishing the importance of innovation, reduces short-term self-interest as a motivator, brings into the foreground the firm’s dependence on its pool of talent, and demands the firm play a palpably positive role in society.

The importance of mature, open leadership by a skillful board chair cannot be overemphasized. Effective chairs capitalize on the wisdom and advice of board members and management leaders and on the board’s interactions with supervisors and shareholders, individually and collectively. Good chairs respect each of these vital constituents, preside, encourage debate, and do not manage toward a pre-determined outcome.

RISK GOVERNANCE

Those accountable for key risk policies in FIs, on the board and within management, have to be sufficiently empowered to put the brakes on the firm’s risk taking, but they also play a critical role in enabling the firm to conduct well-measured, profitable risk-taking activities that support the firm’s long-term sustainable success.

In the financial services sector more than in other industries, risk governance is of paramount importance to the stability and profitability of the enterprise. Without an ability to properly understand, measure, manage, price, and mitigate risk, FIs are destined to underperform or fail. Effective risk governance requires a dedicated set of risk leaders in the boardroom and executive suite, as well as robust and appropriate risk frameworks, systems, and processes.

The history of financial crises, including the 2008–2009 crisis, is littered with firms that collapsed or were taken to the brink by a failure of risk governance. The most recent financial crisis demonstrated the inability of many FIs to accurately gauge, understand, and manage their risks. Firms greatly understated their inherent risks, particularly correlations across their businesses, and were woefully unprepared for the exogenous risks that unfolded during the crisis and afterward.

MANAGEMENT

Management needs to play a continuous proactive role in the overall governance process, upward to the board and downward through the organization.

The vast majority of governance and control processes are embedded in the organizational fabric, which is woven and maintained by management. The board is dependent on management for information and for translating sometimes highly technical information into issues and choices requiring business judgment. Governance cannot be effective without major continuing input from management in identifying the big issues and presenting them for discussion with the board.

Management needs to strengthen the fabric of checks and balances in the organization. It must deepen its respect for the vital roles of the board and supervisors and help them to do their jobs well. It must reinforce the values that drive good behavior through the organization and build a culture that respects risk while encouraging innovation.

SUPERVISORS

Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.

Supervisors have legally defined responsibilities relating to risk control; fraud control; and conformance to laws, regulations, and standards of conduct. Supervisors now seek a deeper and more
nuanced understanding of how the board works, how key decisions are reached, and the nature of the debate around them, all of which reveal much about the firm’s governance. Most FI boards applaud this expansion in the supervisors’ focus from control process details to include a broader grasp of issues and context. To be effective, however, this expansion requires regular interaction among senior people in supervisory agencies and boards and board members.

Supervisors need to broaden their perspectives to include FI strategy, people, and culture. They should focus their discussions with senior management and the board on the real issues—through both formal and informal communications. But they must also maintain their independence and accept that they will at best have an incomplete picture. Similarly, supervisors must not try to do the board’s job or so overwhelm the board and management that they cannot guide the FI.

Supervisors have a unique perspective on emerging systemic, macroprudential risks and can compare and contrast one FI with others. This is vital information to develop and share.

Unfortunately, in the policy-making debate, the qualitative aspect of supervision is sometimes overshadowed by quantitative, rules-based regulatory requirements. Clearly, new capital, liquidity, and related standards are essential to a more stable global financial architecture, but enhanced oversight of the performance and decision-making processes of major FIs is also essential.

**VALUES AND CULTURE**

*Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.*

Suitable structures and processes are a necessary but not a sufficient condition for good governance, which critically depends also on patterns of behavior. Behavioral patterns depend in turn on the extent to which values such as integrity, independence of thought, and respect for the views of others are embedded in the institutional culture.

In a great FI, positive values and culture are palpable from the board to the executive suite to the front line. *Values and culture drive people to do the right thing even when no one is looking.* Values and culture are a fundamental aspect of the governance system, which makes them legitimate and important dimensions of inquiry for supervisors. Values and culture are also important areas for consideration and inquiry by boards. While these soft features defy quantitative measurement, they cannot be ignored. Anyone spending time in an organization quickly develops a clear sense of what drives it: most new employees understand the values and culture of the institution within a year, and many figure it out within just a few months. They instinctively observe how values and culture influence day-to-day business decisions and personnel choices. Supervisors can do likewise.

**SHAREHOLDERS**

*Long-term shareholders can and should contribute meaningfully to effective FI governance.*

Shareholders can contribute meaningfully to the effective governance of FIs. Most institutional shareholders do not have seats on the board but should nonetheless, to the extent possible, be active in oversight of governance, commensurate with their ownership objectives. Boards and management teams should be encouraged to engage seriously with shareholders, listen closely, and factor shareholder perspectives into decisions.
CHANGING THE WAY WE THINK ABOUT GOVERNANCE

The G30 is not the first to reach the conclusion that proper behaviors are the key to effective FI governance. But this report endeavors to describe those essential behaviors and to provide implementable ideas for engendering them.

The key to changing the way people behave is to change the way they think. Accordingly, the paramount aim of this report is to promote among board members, management leaders, supervisors, and shareholders a practical and productive way of thinking about effective governance. Only by changing the way people think about governance can we successfully induce the specific, tailored changes that will enhance governance in each institution.

For example, FI leaders would govern and supervisors and shareholders would assess governance differently if they believed the following:

- Governance is an ongoing process, not a fixed set of guidelines and procedures.
- Diversity of governance approaches across FIs is a virtue, not a vice.
- To get deeper and deeper into the details of all parts of the business may be a choice some boards will make, but endless detail is not a prerequisite for board effectiveness. Boards will need to dig deep selectively, as necessary for understanding.
- Board independence and challenge should bring a high quality and value-additive contribution to board deliberation and is not evidenced by the number of times a director says no to management.
- Having smaller boards that require greater time commitment from their members is a far better approach than having larger boards that require only modest time commitment.
- Non-executive directors, sometimes called “outside board members,” must bring an independent, external perspective.
- Effectively balancing risk, return, and resilience takes judgment. If a risk is too complicated for a well-composed board to understand, it is too complicated to accept.
- Management’s key governance mandate is to give the directors the best means of understanding the business issues upon which judgment is required.
- The best board in the world cannot counterbalance a weak internal control and risk management architecture.
- Supervisors need a deep and nuanced understanding of each FI’s strategy, governance approach, culture, leaders, and issues.
- Institutional shareholders will not prevent the next crisis, but they can and should engage more productively in governance matters.
- Values and culture are the ultimate “software” that determines the behaviors of people throughout the FI and the effectiveness of its governance arrangements.

The list above is not comprehensive. The body of the report contains a host of insights and recommendations with the potential to shape thinking on effective governance.

* * *

16
REPORT STRUCTURE AND CORE MESSAGES

This report is composed of seven chapters, preceded by a list of key recommendations. The chapter subjects and messages are as follows.

1. Addressing the essential question of function
   - Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.

2. The vital role of boards of directors
   - Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy; assessment of risk taking; and the assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy.

3. Risk governance: A distinctive and crucial element of FI governance
   - Those accountable for key risk policies in FIs, on the board and within management, have to be sufficiently empowered to put the brakes on the firm’s risk taking, but they also play a critical role in enabling the firm to conduct well-managed, profitable risk-taking activities that support the firm’s long-term sustainable success.

4. Deep commitment to governance: A requirement from management
   - Management needs to play a continuous pro-active role in the overall governance process, upward to the board and downward through the organization.

5. The role and responsibility of supervisors
   - Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.

6. Relationships between FI boards and long-term shareholders
   - Long-term shareholders can and should contribute meaningfully to effective FI governance.

7. The impact of values and culture on behaviors and decisions
   - Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.
**THE ESSENTIAL QUESTION OF FUNCTION**

Well-implemented governance structures and processes are important, but whether and how well they function are the essential questions.

1. **Diversity in governance approaches reflects unique circumstances.** Everywhere, from the United States to Europe to China to Brazil to Australia, there is convergence around the core roles of the board, management, supervisors, and shareholders. However, the specifics of those roles vary substantially from firm to firm, and from country to country, sometimes subtly and sometimes quite starkly. FIs tailor their specific model to optimize effectiveness under unique circumstances.

2. **Governance systems are defined by both hardware and software.** Governance systems are built around a defined architecture comprising both “hardware” (for example, organization structures and processes) and “software” (for example, people, skills, and values). The software makes the hardware function.

3. **Effective governance depends on people and how they interact.** Effective governance comes down to people and how they interact, whether in the boardroom, board committee meetings, management meetings, or meetings with supervisors and shareholders. FIs need to adopt good governance practices, and they can learn from the experiences of others, but what works best in one situation may not work at all in another. FIs can tailor governance arrangements, but if they have the wrong people, or if those people behave in dysfunctional ways, the arrangements do not matter.

**THE BOARD**

Boards of directors play the pivotal role in FI governance through their control of the three factors that ultimately determine the success of the FI: the choice of strategy; assessment of risk taking; and assurance that the necessary talent is in place, starting with the CEO, to execute the strategy.

Well-functioning boards scrupulously discharge the following 10 essential tasks:

1. **Fashion a leadership structure that allows the board to work effectively and collaboratively as a team, unified in support of the enterprise.** Structures differ from one FI to another. There is no ideal template. Boards with 8 to 12 members are best positioned to encourage candor and facilitate constructive debate.

2. **Recruit members who collectively bring a balance of expertise, skills, experience, and perspectives and who exhibit irreproachable independence of thought and action.** Members with experience in the CEO role, in finance, and in regulation are particularly valuable. Credentials notwithstanding, interpersonal chemistry is an essential determinant of a board’s success.

3. **Build, over time, a nuanced and broad understanding of all matters concerning the strategy, risk appetite, and conduct of the firm, and an understanding of the risks it faces and its resiliency.** All board members should receive structured induction and ongoing training. The clear trend toward deeper engagement between directors and management and between directors and external constituents is to be applauded.
4. **Appoint the CEO and gauge top talent in the firm, assuring that the CEO and top team possess the skills, values, attitudes, and energy essential to success.** A very good CEO is preferable to a “star” CEO. The board must confirm the appointment of independent members of the executive team, including the chief risk officers (CROs) and head of internal audit, and should be consulted with respect to other very senior appointments. Boards should maintain a focus on talent development and succession planning, which are critical components of organizational stability.

5. **Take a long-term view on strategy and performance, focusing on sustainable success.** The board has an inviolable commitment to the long-term success of the firm, which should be viewed in a five-to-20-year time frame.

6. **Respect the distinction between the board's responsibilities for direction setting, oversight, and control, and management's responsibilities to run the business.** It is misguided and dangerous to conflate the responsibilities of management with those of the board. The board's primary responsibilities include: (a) reaching agreement on a strategy and risk appetite with management, (b) choosing a CEO capable of executing the strategy, (c) ensuring a high-quality leadership team is in place, (d) obtaining reasonable assurance of compliance with regulatory, legal, and ethical rules and guidelines and that appropriate and necessary risk control processes are in place, (e) ensuring all stakeholder interests are appropriately represented and considered, and (f) providing advice and support to management based on experience, expertise, and relationships.

7. **Reach agreement with management on a strategy and champion management once decisions have been made.** There is an important role for the board in strategy, but the real development and analysis is clearly an executive function. The board challenges and discusses the proposal with management, revisions are made, details are discussed, and eventually a strategy is hammered out to which all are fully committed.

8. **Challenge management, vigorously and thoughtfully discussing all strategic proposals, key risk policies, and major operational issues.** Effective challenge demands integrity on the part of both the board and management. Management must accept the board's prerogatives and respond positively rather than defensively. Boards must be careful not to undermine their own processes with disingenuous motives. Board members who challenge just to have their challenge recorded are not acting in the interest of the institution.

9. **Ensure that rigorous and robust processes are in place to monitor organizational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations. Proactively follow up on potential weaknesses or issues.** Oversight and compliance are important functions of the board, but boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk governance, and talent issues make a critical mistake.

10. **Assess the board's own effectiveness regularly, occasionally with the assistance of external advisers, and share this assessment with the lead supervisor.** Boards should conduct periodic self-evaluations that include candid and constructive feedback on the performance of directors and committees. They should discuss the findings with their supervisors. Supervisors’ judgments regarding governance effectiveness are better informed with a rich understanding of the board’s internal findings.
RISK GOVERNANCE

Those accountable for key risk policies in FIs, on the board and within management, must be sufficiently empowered to put the brakes on the firm’s risk taking, but they also must enable the firm to conduct well-managed, profitable risk-taking activities that support the firm’s long-term sustainable success.

Effective risk governance within FIs requires several actions on the part of boards and management teams:

1. Establish a board-level risk committee that supports the board’s role in approving the firm’s risk appetite and that oversees the risk professionals and infrastructure. The risk committee’s core mission should be to shape the firm’s risk appetite within the context of the firm’s chosen strategy and then to present it to the full board for approval. It must ensure the risk culture supports the desired risk profile and must ensure risk leaders and professionals are capable, empowered, and independent. It must also ensure the firm has the necessary risk infrastructure in place.

2. Ensure the presence of a CRO who is independent, has stature within the management structure and unfettered access to the board risk committee, and has the authority to find the appropriate balance between constraint and support of risk taking. The CRO must have the independence, skills, and stature to influence the firm’s risk-taking activities. The board should approve the appointment of the CRO, and the risk committee should annually review the CRO’s compensation.

3. Determine a risk appetite that is clearly articulated, properly linked to the firm’s strategy, embedded across the firm, and which enables risk taking. The FI’s risk appetite framework should frame the choices regarding risks in terms of the type of institution the board and management are trying to build and sustain, and it should clearly link risks and returns. To be fully effective, the risk appetite framework must be embedded deep within the firm and linked to key management processes, such as capital allocation decisions, new product and businesses approvals, and compensation arrangements.

4. Actively assess and manage the risk culture so that it supports the firm’s risk appetite. The risk committee and full board play a critical role, with management, in ensuring that the risk culture is consistent with the firm’s risk profile aspirations. The tone set at the top of an FI is important, but non-executive directors also need to be attuned to the culture deep in the organization and how the messages at the top are communicated and interpreted by employees. They should seek out the views of supervisors and the external auditor.

5. Ensure directors have access to the right level of risk information so as to see and fully comprehend the major risks. FI management must strike a balance between being thorough and concise in reporting to the board. They must avoid overwhelming directors with details, while still providing sufficient and unbiased risk information.

6. Maintain robust risk information technology (IT) systems that can generate timely, comprehensive, cross-geography, cross-product information on exposures. Ultimately, the quality of risk information that FI boards and management teams receive depends largely on the quality of the organization’s IT systems. Ideally, FIs need risk IT systems that can gather risk information quickly and comprehensively, producing estimates of their exposures within hours.

7. Maintain an ongoing focus on emerging risks by having a holistic, vigilant view of all major risks, strategic and product creep, excess complexity,
and areas of overperformance. Boards should take a broad perspective when overseeing risk, including operational and reputational risks that are difficult to measure and mitigate. They should look for early warning signs of emerging risks arising from increasingly complex organizational structures and products or businesses with unexpected overperformance.

8. *Strengthen the firm’s ability to withstand exogenous shocks, recognizing that it is impossible to avoid financial stresses when they come.* No FI is resistant to all possible crises, but judicious advance planning and testing increases institutional robustness. Boards and management teams should also examine how their firms have reacted to actual unanticipated events in the past, since historic reactions can be very informative about the firm’s resiliency.

**MANAGEMENT**

*Management needs to play a continuous pro-active role in the overall governance process, upward to the board and downward through the organization.*

For management to play its governance role effectively, it must take the following actions:

1. *Be accountable for the daily effectiveness of the control architecture.* Management must establish a control framework designed to prevent problems, actively monitor the firm on an ongoing basis, and aggressively address issues that arise. Management must ensure employees and executives adhere to company policy on routine decisions. The control framework should be able to elevate issues that fall outside the policy so that individuals do not navigate around policies without proper guidance and supervision.

2. *Ensure control professionals maintain a comprehensive view of the firm’s risks, balancing prudence with encouragement of sustainable risk taking.* Strong controls require independent control professionals. In some instances, they need veto rights. They should not be seen as a police force, however, and they need to enable controlled risk taking as well as constrain it.

3. *Educate and inform directors on an ongoing basis.* The most important thing management can do to foster good governance is to give the board a reasonable chance of understanding the company strategy, risk appetite, and major challenges the company faces. Management must effectively orient new directors and educate all directors on an ongoing basis to enable the board to ask critical questions of management.

4. *Focus the governance dialogue on the key issues and bring the board early into management’s thinking on key decisions.* Governance only works if management has a process for identifying the major issues and presenting them to the board for discussion. Management must be unfailingly attentive to potential new agenda items for the board and its committees and must facilitate effective, ongoing communication between the board and management on key decisions.

5. *Expose directors to a broad set of executives and employees, both informally and formally, so they get an unfiltered view of the company.* Nothing should hinder communication between directors and executives. Directors should be free to talk to the executives, and they should feel confident and comfortable in doing so—the board-management relationship requires no less. However, directors should exercise the privilege of interaction with management with care.

6. *Work continually on modeling and supporting a culture that promotes long-term thinking, discipline, and accountability.* In addition to explaining what is expected of employees, members of management should model the
desired behaviors. Boards and management should articulate the foundational principles or values of the culture and foster their acceptance.

7. Encourage a culture of no surprises, the quick elevation of issues, toleration of mistakes, organizational learning, and punishment of malfeasance. Management must be open and transparent with the board and should promote those qualities throughout the organization. Only when management teams share their concerns openly, and in a timely fashion, can the board understand the issues and provide input or direction.

8. Build a trust-based environment that supports critical challenge and is open to change. Executives have to be prepared for tough questioning and must understand that it is the board’s duty to challenge them. Executives must be ready for the board to reject a proposal. Being open to challenge is a sign of quality management. Constructive challenge is everyone’s responsibility and should be fostered across the organization, upward and downward.

SUPERVISORS

Supervisors that more fully comprehend FI strategies, risk appetite and profile, culture, and governance effectiveness will be better able to make the key judgments their mandate requires.

To enable supervisors to play a fully effective role in the overall governance process, they need to:

1. Understand the overall business, strategy, and risk appetite of each FI, and focus on FI reactions to real-world events. The expanded objectives of many supervisors encourage them to better understand the strategies, business plans, products, and risk appetite of the FIs they supervise. Supervisors should continue to improve the use of stress testing and horizontal reviews, but they should also learn how FIs have reacted to real-world events. Supervisors should look for areas where FIs are performing unexpectedly well and consider the sustainability of that performance.

2. Develop a sophisticated appreciation of how corporate governance works, including governance structures and processes, board composition and new director selection, and the internal dynamics of effective FI boards. Supervisors should seek to understand how effective governance and board challenge occurs in each FI, but supervisors should also safeguard their independence, attending board and committee meetings only occasionally. They can reserve the right to vet and approve new directors, as may be legally required, while leaving board building to the board chairman and nominating committee.

3. Develop trust-based relationships with senior executives and directors by regularly engaging them in an informal dialogue on industry benchmarks, emerging systemic risks, and supervisory concerns. Supervisors’ increasing interaction and dialogue with senior executives and directors on key strategy, risk, and governance issues is a positive trend.

4. Ensure boards and management govern effectively by setting realistic expectations of FI boards and adjusting regulatory guidance accordingly. Regulatory guidance should clearly articulate distinct roles and expectations for FI boards and management. As supervisors develop a deeper understanding of the culture and values that drive behaviors in FIs, they will be better positioned to discuss their concerns or recommendations with FI leaders.

5. Avoid overstepping their supervisory role and allow the board and management to shoulder their respective responsibilities. As supervisors expand the scope of their oversight, they should
reserve the right to step into decisions historically left to management and boards if they determine that those decisions present undue risk with potential systemic consequences. However, they must do so only as a last resort. More frequent intervention risks compromising the clear fiduciary responsibility of management and the board.

SHAREHOLDERS

Long-term shareholders can and should contribute meaningfully to effective FI governance.

To foster good relationships with shareholders, FIs need to engage in the following practices:

1. Actively listen to shareholder perspectives and concerns before issues arise and communicate clearly the board’s philosophy on governance matters of shareholder interest, including compensation, succession, and board composition. Dialogue with investors is critical. By engaging in active communication, boards will stay abreast of shareholder concerns, will be aware of the mood of the investor community, and will be in a position to preempt unwelcome shareholder resolutions through dialogue and early action.

2. Recognize that shareholders are a heterogeneous group and make every effort to honor shareholders’ desire to be heard. Shareholders have diverse interests and perspectives. The wise board must understand divergent objectives and strike the right balance for the long-term success of the institution.

3. Thoughtfully manage their interactions with shareholders in the interest of clarity of message. Most FIs routinely involve only a small handful of non-executive directors in shareholder conversations, which is a reasonable approach. Discussions with shareholders need to be consistent, and the possibility of confusion or ambiguity increases as the number of voices in the process goes up.

4. Decide when to resist shareholder demands, including those raised by proxy advisers, and when to accede to them. Not all shareholders will be happy with the firm’s governance philosophy and plans. Unhappy shareholders may file or threaten to file resolutions at the annual meeting. The board must choose and defend a position in the long-term interests of the institution, which is its primary responsibility, even though that position may sometimes run contrary to the wishes of certain shareholders.

The following points are also worth noting:

5. The UK’s Financial Reporting Council has put forward a useful shareholder code,7 and the International Corporate Governance Network is supporting similar work. Institutional investors globally would do well to carefully consider the work of both organizations. They should comply with the Financial Reporting Council’s Stewardship Code whenever compliance is consistent with the investor’s aims and the constraints under which it operates.

6. Shareholders have an important role to play in shaping governance arrangements at FIs. Shareholders can ask probing questions about governance, offer helpful observations, and otherwise support the FI. They not only have a right to be heard, they have an important voice in the governance process.

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7 The UK Stewardship Code can be found at http://www.frc.org.uk/corporate/investorgovernance.cfm.
VALUES AND CULTURE

Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.

Although values and culture cannot always be measured quantitatively, they impact governance effectiveness in powerful ways and therefore should be a major focus for the supervisor. The following views and recommendations highlight the importance of values and culture and the hard work involved in getting them right:

1. Honesty, integrity, proper motivations, independence of thought, respect for the ideas of others, openness/transparency, the courage to speak out and act, and trust are the bedrock values of effective governance.

2. It is for the board of directors to articulate and senior executives to promote a culture that embeds these values from the top to the bottom of the entity. Culture is values brought to life.

3. Well-functioning boards set, promulgate, and embed these values, commonly in the form of a code, so that directors, senior executives, and all other employees in an entity are fully aware of the standards of behavior that are expected of them.

4. Because of their power to influence behavior and the execution of the FI’s strategy, values and culture are essential dimensions of inquiry and engagement for supervisors. Major shareholders or their fund managers should be attentive to the culture of an entity when making investment decisions and engaging with an investee board.
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Former Chairman, President Barack Obama’s  
Economic Recovery Advisory Board  
Former Chairman, Board of Governors  
of the Federal Reserve System

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for International Settlements

Jaime Caruana  
General Manager, Bank for  
International Settlements  
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International Monetary Fund  
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Member, Board of Directors, Bank  
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