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PROCEEDINGS REPORT

"The aim to improve director training is a cure for the box ticking attitude that took place around corporate governance standards and that kept our eyes off the real developments of the global financial crisis"
-***Mats Isaksson***, Head, Corporate Affairs Division, OECD

Background

The Global Corporate Governance Forum (Forum) sponsored an international consultation to serve as the launching event of the Forum's financial markets recovery project. Initiated in May 2009, the project's objective is to create sustainable in-market capacity for financial institution board leadership and director training by national and regional institutions.

The consultation examined the diverse challenges faced by private sector financial institutions in improving their risk management, with particular focus on how to improve board and director risk management decision capabilities. The discussion, held in an invitation-only, roundtable format, occurred on 19 June 2009, at the World Bank office in Paris and featured senior-level banking leaders, experts on risk oversight in banking and financial institutions, regulators, representatives from national

institutes of directors, donors, and international organizations that together represented all regions of the world. The agenda and list of participants are attached as Annex 2 and 3, respectively. The Forum's financial markets recovery project, as well as the Paris consultation, is made possible through the generous contributions of OeEB, Luxembourg and the Netherlands.

The Paris roundtable followed the initial conceptualization of the project and a number of seriatim consultations (both internal and external), and was designed to further refine the issues, as well as to reality test the general project design.

Discussions took place around four thematic issues:

(1) the corporate governance weaknesses in banks that contributed to financial crisis;

(2) the role of Boards of Directors and the desired, but frequently missing, skill sets of non-executive directors in light of lessons drawn from the crisis;

(3) the likely effects of the financial crisis on banking regulations, and;

(4) how different banking models affect risk, thereby affecting what constitutes effective risk management for those different banking models.

These sessions were supplemented by a case study presentation of the impact of the financial crisis on Brazilian banks. In addition, participants deliberated informally on three table-top topics during the lunch break:

(5) what should be included in the training for non-executive directors of emerging markets banks?

(6) how to measure success in training bank directors? And;

(7) what is the role of a director in a crisis situation?

The summary recommendations from these table-top discussions are attached as Annex 1.

The dialogue and diverse perspectives contributed by participants provided guidance, recommendations and a set of strategic priorities that will help the Forum orient the risk management content of a supplement to its Board Leadership Training Resources so as to best support director training and improved board competencies, specifically in banks and financial institutions in emerging markets.

However, it is important to note that at times the dialogue revealed clear differences of opinion, even with qualified interpretations on major topics and even where there may have been general consensus. Often they were differences of degree, but occasionally they were true differences with regard to fundamental questions. This is to be expected: the subject is complex and difficult.

This report covers the spectrum of views expressed on both controversial and non-disputed issues. It seeks to contribute the rich spectrum of analysis that emerged to timely and wider ongoing corporate governance debates. Thus, this report does not offer official policy positions, definitive answers, nor reform prescriptions to many of the vexing problems exposed by the global financial crisis. Rather, it informs the financial market recovery project as it advances.

Corporate Governance Weaknesses and Rethinking the Skills Sets for Non-Executive Directors

"The vogue is for superstars and diversity in boards. In fact, the essential element is to secure a knowledge of financial and banking business issues within your board, starting with a certain minimum level of expertise."
-**Hala El-Said**, Executive Director, Egyptian Banking Institute

Participants had general agreement that the performance of boards left much to be desired in light of the financial crisis, with some pointing out that it was too polite and too forgiving to simply state that boards had not performed very well. A variety of analyses have documented many of the problems that exist with the functions and composition of bank boards of directors. The weaknesses are many and well known. The following were cited prominently in Paris:

- **There are flaws in the way that independent directors are selected**, in their independence, and their expertise. Independence has been a mantra over the past few years, but in practice this has often meant selecting directors who, while intelligent and generally competent, do not know much about the business they are charged with overseeing. In effect, **independence has been a barrier to domain expertise in the boardroom.** At the same time, there may have been insufficient independence due to the methods by which such directors are selected and appointed. For example, the selection process should normally happen through nomination committees, but *de facto*, CEOs tend to influence and impact the overall independence process. At another level, it may be difficult to define the desired independence, some of which is independence of thought,

and the ability to think critically about what management presents. The source of this difficulty is that **the definition of independence revolves around negative criteria** (e.g. no former executive, no family ties, no conflicts of interests, etc.) **rather than by positive criteria such as independent thought, due to the difficulty in objectively judging such criteria.**

- **The transmission and channeling of information to boards remains an issue of concern.** Questions were raised not just about the need for more open and transparent information flows, but also about whether the correct information reaches boards, in what format, and in what time frame. Normally, boards obtain their information through management. In some cases, the CEO not only is the only management representative on a board, but also dominates the information flow to the board. Clearly such single channels are unacceptable. **Directors need to receive information from multiple conduits.** They should have the right to directly contact lower management levels within a company, going as deep as necessary to obtain information. The goal should be towards more open communication and more direct access to information.

- **The risk management and risk analysis functions are weaknesses at some banks and require serious overhaul at those institutions.** When the roundtable examined the reasons why some banks escaped the crisis, they found that their risk management culture was much stronger than anyone else. A point was made that anticipation and measurement (as necessary as they are) do not, in and of themselves, equate to a robust risk management culture. Rather, robust risk management cultures stress agility and resiliency following the discovery of an unexpected risk. In other words, **the management, not the measurement, of the risk is key.** The report by Nestor Advisors, *Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks*, for example, shows how BBVA and Santander had superior risk management cultures than its competitors, with Santander dedicating on average two meetings per week to this critical function. Goldman Sachs was cited as another example that illustrated the principle that it is not superior knowledge that mattered, but rather the organizational commitment to follow through when the oversight gave warning of a possible problem. In short, superior follow up, often overlooked in the search for the latest and greatest risk metrics, is the key lesson.

- **Boards lack sufficient technical knowledge of banking business.** Again, it is interesting that in looking at the findings of the Nestor Advisors report, **the banks that were best able to resist the crisis where those where the Chairmen had a very deep knowledge of the firm and its business.** While there is certainly a

role for generalists on a bank's Board of Directors, there is also a need for board members who have a deep technical understanding of what banking is all about, especially given the complexity that currently drives the financial industry. **Both naïve and informed questions are necessary to give the board as a whole the accurate picture of a bank's processes and controls.**

- **Poorly-structured remuneration. This issue awakened passionate debate and diametrically opposing views and recommendations** in the discussions of corporate governance and regulatory reform. Some participants advocated making remuneration inversely related to risk. Others argued that remuneration schemes should be tied to the overall performance of an organization over the long-run, and not as short-term incentives to individual employees. In the end, a **general view seemed to form around the idea that there is a clear relationship between risk, excessive risk, and how remuneration incentivizes various actions and types of risk-taking.** The challenge is to understand those incentives and align them with a considered and desired risk profile for the bank.

- Relationships with shareholders, and resultant **shareholder monitoring of management and boards, was weak and ineffective.**

- Where were the auditors? Participants asked why auditors failed to see the risks and losses that were building in portfolios. **Participants raised fundamental points regarding the role and function of audit committees.** Unlike non-executive directors generally—who some saw at a disadvantage because they do not have day-to-day exposure to bank business and its information—auditors and audit committees were seen as key early warning systems for identifying problems and risks. Because of their full access to a bank's information, the suggestion was made to focus on these mechanisms as an early-warning risk system to prevent problems from escalating or happening in the first place.

A major and recurrent topic of discussion was the very difficult and nuanced question of what level of expertise should be required of non-executive directors individually, and what constitutes sufficient expertise in bank boards overall. Those variables, in turn, depend largely on how boards are chosen and who does the choosing. As per Basel II, boards must have the expertise to know and understand the structure of their bank and their products. In this financial crisis, for example, it was surprising to learn that many boards had very little knowledge about consolidated subsidiaries, contingent liabilities, and other exposures which threatened, and, in some cases, sank balance sheets of major banks. Boards either failed to receive or request

from management an overview of a bank's full structure, including subsidiaries deemed unimportant.

It was also surprising how little banks understood their financial products. Because of testimony to the UK Parliament, we learned that the number two at a large UK bank admitted that he failed to understand his bank's products even after several attempts to do so. The result of the lack of domain expertise and specific knowledge of the particular institution was over-reliance – to a fatal level – on very high-level mathematical modeling rather than real knowledge. That reliance made it impossible for non-executive directors, or, in this case, even management, to exercise judgment; a critical responsibility for boards of directors. Put simply, getting a model print-out of risk is not sufficient and does not substitute for understanding the bank's business lines and products. There was **general consensus that boards must have a sufficient level of knowledge and understanding of specific products and businesses in order to fulfill their fiduciary obligations.**

All of the above speaks to the importance placed by participants on training and developing the capacity of non-executive directors in banks and financial institutions. At least some members of Boards must command high levels of financial literacy, and need to be involved in assessing liquidity risk and stress testing mechanisms, among other risk monitoring and measuring strategems. That is not to say they need to be involved in the day-to-day risk measurement of the institution, but that they need adequate grounding in the methodologies, assumptions, quality of information going into the models, and assurance of information being reported to the board, if they are to credibly challenge management and fulfill their functions of setting risk appetites for the bank and in overseeing management.

General business backgrounds, high ranking profiles, or well-standing reputations are desirable but not sufficient skill sets. These general traits must be complemented by experience, domain-specific expertise, or training specific to the banking industry. This point was reinforced by cases alluded to in some emerging markets, where regulators approve the selection of bank directors weighing fit and proper mechanisms—i.e., the independence, integrity, and objectivity of candidates—but rarely, if ever, assessing or making a determination on the financial competence and expertise of approved nominees. **If there was one item on which literally everyone at the table agreed it was that banks are different than non-financial businesses and specific, deep, domain knowledge is necessary on a bank's board of directors.**

While demanding expertise and involvement by non-executive directors, **participants also recognized that too many expectations are placed on boards and often we expect them to do much more than what is realistically possible.** One participant

said we seem to be calling for boards of Supermen and Superwomen, and that we need to be realistic about human motivation and average human capability. Looking forward, the participants concluded that we are setting up ourselves for disappointment if we rely solely on boards as the only solution for all banking issues. Thus, **recommendations and solutions proposed by participants stressed other links in the corporate governance chain as a way to lessen the focus on boards.** The other market mechanisms and gatekeepers mentioned included regulators, auditors, institutional investors, rating agencies, proxy agencies, advisory services, lawyers, and accreditation bodies.

While the experts found it easy to prescribe the ideal functioning of corporate governance standards and best practice principles in theory, they acknowledged that such theoretical constructs fail to account for practical operational challenges. Thus, a regulator or supervisory body may conclude and communicate to a bank that its board is suboptimal, as was the case in one situation described, but it becomes impractical for many reasons for the bank to replace its board and even less so for the regulator to mandate the removal of members. In the end, **solutions must be found that leverage enforcement systems so that corporate governance codes and standards play a real role in dealing with future dangers and crises seen forming.**

More or Less Banking Regulations?

"A rule is not the end of the game. It forms part of a broader governance framework and leaves open the critical question of how it is applied and who chooses to apply it"
-***Christoph Winzler***, Swiss Bankers Association

As might be expected, once the discussion turned to the issue of regulation, the key debate revolved around whether more or less regulation was needed. As participants noted, **regulations are already in place to avoid, prevent, and sanction undesired ill behavior.** They cover everything from liquidity, internal controls, capitalization, leverage, to money laundering and consumer protections, and are designed to promote stability and a functioning banking system. One view was that principles-based regulation has been shown to be lacking, and, in turn, that solutions lie more in line with full-blown prescriptive regulation that can correct the problems that led us to this crisis and prevent them from happening again. On the opposite end, some argued that calls for greater regulation are really no more than calling for implementation and enforcement of existing principles, though both sides agreed with a need to revisit

current principles in order to strengthen key gaps exposed by the current crisis. Both sides also had the same objective in mind: Imbedding risk management as an integral part of a bank's culture and strategy, with full transparency and clear lines of responsibility and accountability across all levels of a bank's organization.

Participants touched upon some key issues that will surely form part of coming regulatory revisions and new oversight frameworks such as: different regulations for different banking activities and different banking structures; capital requirements; cross-border cooperation, particularly on topic of ring fencing liquidity; reliance on third parties for due diligence, such as rating agencies; and information assurance and flows in relation to risk management. Of course, the issue of debate then became what regulators can do or should do with respect to such topics, and what level of specificity should be written into regulations. From a training perspective, the issue is less polemical and more straightforward. **The key is to build the expertise of directors who must be attuned to both the underlying issues and the on-going process of regulatory reform.** Additionally, there was agreement that directors needed to insist on communications structures that not only inform them of new regulation, but educate them as to why regulators felt the need for the new rules. Moreover, it was pointed out that new regulations always raise fundamental strategic considerations because of their potential impacts on specific banking business models.

Participants were reminded that **specific regulation largely depends on the political system of each country and that its scope is beyond what experts or specialized committees can address**, even within fora such as the OECD or Basel Committee. Moreover, over the last 10 years there had been noticeable erosion in the powers of regulators in most jurisdictions, particularly in the West. Previous powers to address or investigate anything that introduced risk to banking organization, whether by an affiliate institution, an activity or related party, have been scaled back. Even where the powers were not scaled back, the will to be aggressive and the resources needed to be effective, were often reduced, or, at a minimum, did not keep pace with the growth of complexity in the banking system. As the Turner Review report, *A Regulatory Response to the Global Banking Crisis (March 2009)*, powerfully illustrates, regulators did not have the resources to enforce principles-based regulation nor many powers to enforce it. Participants also noted that **in some emerging markets, the powers of the regulator are typically broader and less constrained than those observed in Europe or America, but effective regulation is thwarted by issues such as poor salaries, minimal training, or a lack of resources in some jurisdictions.**

Also, as multiple supervisory agencies grew in momentum, with concomitant competition among them, more and more regulatory gaps emerged as everyone tried to avoid regulatory overlap. It is hard to say whether overlap or gaps are worse, but it is

surprising that many key powers simply do not exist in many countries, among them: The ability to address the quality and training of board members, the ability to commission expertise, or the ability to go on-site and conduct qualitative reviews of risk systems. Each country has to determine for itself the best mix of this delicate balancing act, but **regulators must have regulatory powers to get into banks and talk to bankers if they are to learn, understand, and cross-compare experiences.**

The Basel Committee's eight high-level principles issued in 2006, *Enhancing Corporate Governance for Banking Organizations*, were cited as examples of sound and best practice principles already in place. The Basel Principles apply to a wide range of banks and countries, regardless of whether a country has adopted Basel II or not, and cover many of the central issues that are being advocated in the regulatory reform discussion. **The need is to build upon, not reinvent, good practices, nor to duplicate existing capacity.** Thus, it is worth citing these eight high-level Basel principles:

- Principle 1: Qualified board members
- Principle 2: Strategy of firm has to be endorsed by board
- Principle 3: Clear lines of responsibility and accountability
- Principle 4: Appropriate oversight of senior management by the Board
- Principle 5: Board has to make effective use of work conducted by audit function
- Principle 6: Board to establish compensation and governance policies
- Principle 7: Board has to be transparent
- Principle 8: Board needs to understand bank's operational structure

These and many other sound principles remain valid and legitimate, taking into account that their effectiveness to date has been more a function of awareness, application, and enforcement than any inherent inadequacy.

Another key topic of discussion dealt with the relationship between boards and regulators. There was a consensus for regulators to take on a more active role (whether through new or existing regulation). Again, the starting point was the recognition that the banking sector is very different and not just like any other industry and that **the global financial crisis reveals that banks are public concerns, which if plagued by serious problems, can lead to disastrous societal consequences.**

Certainly in the case of the commercial banking sector, banks form part of the functional infrastructure of society, akin to the role served by a country's electricity grid. As such, the answer as to whom bank board members have a fiduciary duty becomes a critical one. The traditional corporate governance answer points to accountability to shareholders and responsibility to shareholder value. **But the discussion paralleled**

the current academic literature, and asked if board members also have a fiduciary duty to the general public and to regulators. <u>This is not a trivial rumination.</u> Different answers provide different points of departure in how to conceptualize training courses on the roles and duties of boards of directors in banks and financial institutions.

In short, training materials are to convey important points for banks and board members to internalize and think about, and then they must address their relationship with regulators as a first step. More broadly, the relationship between banks and society generally was discussed, with proximate manifestations of that relationship being issues such as moral hazard, "too big to fail," deposit insurance, politically directed lending, etc.

Participants considered the merits of expanding fit-and-proper tests by regulators to include competence in various financial and banking technical areas, such as risk management, etc. One suggestion was to mandate some form of compulsory training in specific banking areas as a consideration into the "fit-and-proper" determination. Thus, regulators would not only have to be able to assess the normal baseline character issues, but also handle the more difficult task of defining minimal levels of domain expertise.

As an alternative, a participant stressed that selecting the correct people is the key to bank board competency and noted that, regulators seldom object as long as the person has a good reputation and no criminal record. That participant suggested that regulators could select appropriate individuals, or at least veto those without competencies. However, that alternative was considered overly complex and/or heavy handed by some. A number of people did suggest, however, that there is room for greater dialogue on the nature of proposed candidates. Regulators have the opportunity to be more challenging by raising questions about what the candidate will bring to the bank, how competent he or she is, whether it is someone with a complementary skill set needed by the bank, etc. Such dialogue rarely takes place, which is understandable in that it is sensitive and difficult for regulators to intervene in any selection process. But with dialogue as an option, one can avoid the alternative polar choices between unchallenged acquiescence and compulsory criteria. The call, therefore, was for the practical, non-bureaucratic, under-used, and under-valued approach of advancing greater interaction between the banking community and banking regulators.

Overall, **participants were skeptical about too much intervention from regulators, especially for choosing board members or imposing certain levels of training and competence requirements, noting that Board effectiveness is not solely dependent on qualifications, but also about intangibles that make it possible for a team to work together.** These dynamics cannot be neglected and should not be

secondary to the call for greater banking competence. As would be true with almost any selection criteria, two experts who reflect the ideal competence in their respective fields, yet together, may be a dysfunctional working combination. The process by which boards become effective decision-making bodies is not only a difficult challenge, but also somewhat opaque for outside parties (including regulators) to assess, much less prescribe it by criteria.

In conclusion, the participants felt that in addition to whatever formal regulatory changes will occur, two other aspects of an effective regulatory regime should not be lost:

(1) Better enforcement of existing regulatory regimes should be high on the agenda, and;

(2) Viable and effective solutions require overcoming the fragmentation that is typical of most domestic regulatory arrangements.

Ultimately, participants believed that regulation should follow some key guidelines: it should be understandable, essential, complete, with no loopholes, consistent (to avoid regulatory arbitrage), concise (no need for 300 pages), at appropriate level of detail, and based on principles of proportionality and subsidiary. **Both systemic and prudential regulation should be risk-based.** But above all of these, good regulation must have implementation. Without it, there is simply no such thing as an effective regulatory framework.

Risk in Different Banking Business Models

"The world is moving fast in embracing products without developing the capacity to manage its risks appropriately. There must be a broad-based initiative to build capacity and match it to the risk levels of product innovations taking place"
-***Aig Aig-Imokhuede***, CEO, Access Bank Plc., Nigeria

How can directors ensure their bank manages risk effectively? Do directors need deep domain expertise, or does it suffice for them to exercise *bona fide* due diligence of management's processes and controls? What can one realistically expect/demand from bank directors? With the benefit of hindsight, we know that regulators, executive teams, auditors, investors, and the vast majority of all other market players got it wrong with respect to risk building up during this crisis.

However, **at a minimum, the participants asserted that directors must have the ability to understand and question the nature of business models, and the nature of the risks inherent to each banking activity and its operational structure, including impacts brought upon by ongoing change and reform within the regulatory landscape of the financial sector.** Even those mandates require a huge time commitment, as well as expertise, from directors.

The consensus was that if we require directors to act in a superhuman way just to meet their oversight requirements, we will be guaranteeing failure. After a certain point, normal, human directors will have asked the right questions, and exercised their due diligence as reasonably as one can expect. That is not to either minimize the role of directors, nor to excuse any particular director or set of directors who does not exercise full capacity in fulfilling their duties. Rather it is to note that beyond such a point, other actors within the governance chain become critical compensating factors and must act in this fashion.

A 2009 INSEAD study (Professors Harald Hau and Marcel Thum, *Subprime Crisis and Board (In-)Competence: Private vs. Public Banks in Germany*) was cited as demonstrating that differences in business models, as well as board competence in finance was directly related to the magnitude of financial losses from the global financial crisis in 29 large banks in Germany. While not overstating the import of that or any single study, the participants said it indicated that other important considerations, such as a bank's legal form; whether banks are quoted on a stock exchange; size and scope; complexity of growth in different areas of banking activity; and whether banks are in partnership rather than joint stock form could have a bearing on their risk profiles, risk management capabilities, and resiliency.

The partnership form of banks was described as a rare and disappearing form, but one that powerfully illustrates the deep influence of corporate culture on different banking business models. In a partnership model, not only do partners have unlimited personal liability for the obligations of the bank, but there is also a cultural element in that partners feel a sense of commitment to each other.

A serious discussion of culture ensued, including a generational perspective. Participants referred to three very distinct phases of banking culture evolution since 1929 which may have had an impact and may help explain differences in the culture of individual banks. The first phase involves the individuals who lived through the 1929 crisis. They suffered through the crisis and were deeply shaped by their personal exposure to it. They are the ones who said they never again wanted to live through such a crisis and took decisive actions to prevent future occurrences

Immediately following came the second phase, which was a generation that learned from and was mentored by those that lived through the painful period of the first phase. As a result, the training received by the second generation of bankers consisted of a series of very basic principles which remain valid to this day:

- *Do not lend because you have good collateral, lend because you have a good borrower*
- *The essence of banking is liquidity, and one should distinguish between liquidity and solvency. Solvency is relatively easy; liquidity is not*
- *Do not do what other people do just because they do it*
- *Watch for warning signs: When a deal gives you a profit that seems outstanding, be extremely vigilant*
- *If you grow too fast, watch your institution carefully*
- *Get your incentives right: do not exaggerate the incentive for the individual. Link it as much as you can to the institution as a whole; and do not do it short term, do it long term*
- *Do not touch what you do not understand.*

None of the individuals from the first phase – those that lived through the depression are running banks today. In fact, by 2009, few of the people those individuals trained – the second phase -- are running banks. We have outlived both the searing experience of the depression, and, to a large extent, the generation who adopted the common sense attitudes towards risk that it fostered.

The third phase was characterized by an increase in size of the banking sector relative to the rest of the economy; by banking moving away from direct lending and into securitization and other non-traditional activities; and by a fundamental change in the nature of bankers' risk appetites. Rather than caution, this time period was characterized by fear of missing out. As a result, people jumped onto poorly understood investments for fear of being penalized by staying away. The participants noted that the simple principles of the first two generations might be mocked as platitudes but that does not subtract from their relevance and effectiveness. The generational discussion was, to some extent, a reaffirmation of the calls for judgment, rather than second-decimal point mathematical modeling with which the roundtable began. With the benefit of hindsight, it was thought that if those principles had been followed in the decisions leading to this financial crisis, we could have avoided many of the problems which sophisticated quantitative models failed to warn about or manage away.

It was noted that selective memory was a human trait, and that the farther removed from the 1930s recession the less aware were each succeeding generation of bankers as to the lessons learned of that period. While that was cited as a negative contributor to the global financial crisis of 2007-2009, the nature of human memory was also cited as a positive for the near and intermediate future. If learning from other people's mistakes is difficult unless you have gone through your own, then the silver lining today

is that our own crisis presents an opportunity to rekindle the education for the next generation of bankers and directors. They should be more willing to listen than at any point in the past 75 years. Consequently, **training and capacity building are poised to become central and fundamental pieces in building a more stable and robust global financial system.**

Brazilian Banks and the Financial Crisis

"While it took regulators time to realize the extent of the problem, they acted promptly, swiftly and decisively."
-***Mauro Rodrigues da Cunha***, President, Maua Investimentos Ltd.

After a day in which the focus was on failure in the face of the financial crisis (the failures of directors, regulators, auditors, etc.), **the examination of Brazilian banks afforded participants a study of how a well developed financial system was able to manage the crisis and avoid the near collapse experienced by many other jurisdictions.** It also demonstrated how lessons learned from past crises can positively prepare a banking system for future crises, even when the proximate causes of the distress differ.

Brazil enjoys a resilient and large banking sector, characterized by good capitalization and an efficient use of information technology. The industry's total assets are valued at US$1.5 trillion, with total deposits of US$750 billion. Credit over GDP, which has been growing incrementally, is at 43%. Two Brazilian banks have market capitalization in excess of US$50 billion, which place them among the largest banks in the world. In addition, the use of advanced technology has allowed the industry to have a large network able to reach the smallest villages and remote areas. This technology has also enabled the industry to expand in its retail banking, while lowering costs at the same time. For instance, transfers up to US$1200 are free of fees

Partly as a result of lessons learned from inflation, which Brazil suffered for many decades, and partly because of a series of financial crises experienced over the years, the Brazilian Central Bank developed robust financial regulations. For over 20 years, Brazil has recognized the importance of prudential regulations, which have been further strengthened in the past five years. For instance, while Basel II accord dictated that banks cannot carry capital adequacy ratios below 8%, banks in Brazil kept ratios well above these requirements; usually above 15% while keeping a return on equity in the range of 25% for large banks and 10-15% for smaller banks.

The governance structure of Brazilian banks, typical of many emerging markets, with a

control group dominating ownership, was also cited as an ameliorative factor in the crisis. The Brazilian Central Bank mandates that there be a controlling group in the ownership of banks. Legislation places a strong emphasis on the personal responsibility and liability of directors, managers and shareholders. These groups are personally liable for bank failures. Whatever the other advantages of the Anglo/American diverse ownership structure, the Brazilian model makes for clear accountability; everyone knows who is in control and who is responsible should things go wrong (or right).

There is also a high state participation in the banking sector. State-owned banks, notably Banco de Brasil, Caixa Econômica Federal, and Banco Nacional de Desenvolvimento Econômico e Social (BNDS), are responsible for more than 30% of total credits in the economy. In effect, **what was always seen as a flaw in the Brazilian system came to be perceived as one of the major financial safeguards during the financial crisis, as these state-owned banks represented stability.**

Since 2002, the Central Bank developed an automated view of the banks' financials on a monthly basis. Stress tests were also conducted on a regular basis. This allowed a very prompt and targeted reaction. Some of the reserve requirements were relieved in the sense that large banks could buy credit portfolios of smaller banks. The Central Bank also guaranteed deposits for up to 20 million Reais (US$11 million) for smaller banks, which bolstered stability and confidence in these banks.

Combined with the regulatory response of the central bank, the securities commission-- Comissão de Valores Mobiliários (CVM), an independent body-- and the treasury were very effective in building trust back into the financial system during the crisis. Full consolidation of banks' balance sheets allowed the market to understand the picture of bank health. This had two effects. First, systematic market risks were more visible. Second, there was no "AIG" scenario in which a relatively obscure, ignored part of a financial institution could build up liabilities that threatened both that institution and its counterparties. Companies and banks were required to give better disclosure on derivatives as well as provide scenario analysis on their entire derivatives portfolio following the crisis. These derivatives, while not as prevalent as in some other countries due to local conditions, posed a considerable potential impact during the crisis. Accordingly, while it took the supervisory authorities some time to understand derivatives' realized and potential impact following the onset of the crisis, the disclosure requirements allowed for a quick turn around in the situation -- a process which was praised by many in Brazil.

Finally on the role of boards in Brazil, **all directors and senior managers not only must be approved by the Central Bank, but they also undergo a "no objection" public consultation.** In addition, supervisory banking authorities regularly interview

board members to make sure that they are adequately involved and engaged with the board's functions of the respective institutions. An interesting aspect in the Brazilian case is the role of audit committees. Beyond their normal responsibilities, **audit committees have a duty to report any malpractice that is not resolved by the board directly to the Central Bank.** This gives them more authority (as well as a duty) to monitor the health of their respective financial institution. On the other hand, given the concentration of ownership found in Brazilian banks, non-executive directors had a limited role in identifying the issues behind the crisis. In practice, it was the owners and internal auditors of banks who were able to identify problems early on. This demonstrates an asymmetry of information that is characteristic across the banking industry and which necessitates due attention and improvements no matter what the governance structure.

Conclusion

In the aftermath of the global financial crisis there continues to call for big solutions and large-scale regulatory reform. The severe economic pain that is afflicting a large majority of the world's population has called into question the effectiveness of many corporate governance arrangements. We have discovered that many of the key actors, even at the apex of boards, simply did not understand their duties or did not posses the necessary skills-set to perform their roles. Without the necessary orientation, training, and capacity building, board members are limited to a form of box-ticking compliance. That rote mentality undercut their role as lynchpins of corporate governance at their individual banks.

The deliberations of the Paris consultation clearly highlight that solutions will require tailored adaptation, flexible application, and a delicate balance between self-regulation, mandatory rules, and national priorities. The pragmatic and realistic approach lies somewhere between greater self-discipline by individual banking organizations and greater regulatory powers that can enforce existing principles of best practice governance and risk management. In a sense, it is an approach that challenges individual banking organizations to leverage solutions within their own reach and champion ethical and corporate cultures that are built on true-and-tested banking principles.

As the Paris consultation demonstrated, dialogue and on-going discussion lead to mutual learning and understanding. In the end, there was a level of consensus that banking directors do need some level of expertise, that enforcement is needed for any regulation to be effective, that we do not need to reinvent the best practice principles

that already exist, that **boards are the frontlines of tomorrow's critical corporate governance issues, and that training of bank non-executive directors is a key foundation stone for boards to work better in the future.**

Finally, an analogy was introduced to highlight how managing risk takes on a different character when looked at from differing perspectives: Managing financial risk was compared to managing risk within a nuclear power generating company. Given the obvious dangers of a nuclear accident on the nearby community, the environment, future generations of a large percentage of the population, there is no doubt that we would want to assure the technical capacity of board members who would be supervising the risks around the processes of the nuclear plant. It was pointed out that the risks that banks and financial institutions present to national economies and global stability can be likened to those of the nuclear plant, yet we look at banking risks as non-technical issues that can be managed and assured by non-technical directors. Judged from the perspective of the analogy, such practice was deemed as unacceptable. Instead, the governance of banks and financial institutions should recognize that risk has a technical dimension. And given the higher probability of future financial crisis than a nuclear accident—particularly because by definition banks make money by taking risks and will never shy away from it—then the appeal was to **govern risk properly and by boards with both technical competence and judgment.**

In effect, the participants urged that this crisis be viewed as an opportunity—by nature of our direct exposure to the scope and proportion of its worldwide consequences—to redouble commitments to implement, follow-up and enforce the standards left dormant in the build up to this crisis. **As we craft and introduce new governance and regulatory architectures, they must go hand-in-hand with board training and capacity building measures that are tailored to the different needs and circumstances of emerging markets and industrialized nations.**

Specific suggestions for the risk management supplement for the training of directors of banks and financial institutions are set out more fully in Annex 1.

Annex 1

FINANCIAL CRISIS RESPONSE CONSULTATION
19 JUNE 2009

World Bank Paris Office
66, Avenue d'Iéna
Paris, France

During the lunch period of the Paris consultation, participants divided into three groups to discuss and explore three topics. A summary of each group's main findings and recommendations follows:

TOPIC 1:
How do we ensure that we are preparing bank directors for the next crisis, not the last crisis?

Discussion leader: Christoph Winzler, Member of Senior Management, Head of Financial Markets Law, Swiss Bankers' Association

Rapporteur: Laura Ard, Lead Financial Sector Specialist, World Bank

The group agreed that in order to prepare for the next crisis, there is a need to focus on process rather than box ticking and rules. Specifically, the call was to focus on processes that could be either upgraded or introduced in five key areas:

1. Information flows

The group felt a major focus should be on the availability, integrity and design of internal information provided to the board. This should be designed to improve the dialogue with business lines and external parties as a way to grasp the real pulse of the market. Disclosure of information regarding important events of the company should be conducted on an ongoing basis. This should include financial as well as any other developmental events that could better inform board decisions. The group recommended that this information should be posted on the company's website in order to inform shareholders and the market. They noted that this is already the case for some listed companies.

2. Incentive structures

The group focused on middle management incentive structures. It recommended that remuneration needs to be balanced and aligned with sustainable performance and the longer-term safety and soundness of the institution.

3. Board processes

The group underscored the importance of board members' soft skills, such as the cohesiveness and dynamics of the board. In this regard, it was felt that selecting board

members with the ability to question their counterparts and management and the information furnished by middle management was key. "*There needs to be a focus on intuition and the ability to question; to sense issues early on by turning a suspicion into a story and start validating it,"* highlighted Laura Ard in her report to the plenary session.

4. Shareholders

The group agreed that shareholders need to be more accountable but this is currently not possible unless they get more information. The process was characterized as a circle of information paradox and raised the question of who should initiate a change in shareholders' disclosure of their stewardship activities of the companies they own. Suggestions included a possible role for large institutional shareholders to start actively disclosing their voting records as well as to exercise pressure in order to spur boards and management to produce better information.

5. Constant surveillance

The group considered it essential to raise the level of regulatory surveillance of not only the firm, but the market as a whole; as the liquidity crisis was clearly a failure of the regulators (and many others). In this regard, it was felt that regulators must monitor what is happening in the market place and what competitors are doing, including, for example: what new products are coming online and their pricing mechanisms. This will require a constant dialogue with key players who have a direct contact with the market such as traders and analysts who generally have a better feel of the market and its developments. On these issues, the group recommended focusing on market scenarios in the context of overall risks rather than focusing solely on the surveillance of institutions.

Finally, the group underscored the importance and role of the financial statement and highlighted the need to upgrade external market mechanisms to enforce good financial system disclosure.

TOPIC 2:
Measuring Success: How do we know if we succeed in training directors of emerging markets?

Discussion leader: Emmanuel du Boullay, Founder and President of FINCA & Co-founder and Director of the Institut Français des Administrateurs (IFA, French Institute of Directors)

Rapporteur: Prof. Sidartha Utama, Chairman, Indonesia Institute for Corporate Directorship

Before exploring the measurements for success, the group developed a set of objectives for any initiative to train banking directors in emerging markets, as follows:

- Short-term objective: Improve the capacity and capabilities of local training institutions to provide training to directors

- Long-term objective: Increase the effectiveness of the board in performing its duties.

While setting these objectives, the group recommended broadening the target audience to include non-independent directors and even shareholders (especially major shareholders). The group highlighted that this will improve the effectiveness of the project given the structure of ownership in most emerging markets (which is largely dominated by controlling or majority shareholders in both listed and non-listed companies). Hence, majority shareholders play a very important role in advancing the practice of corporate governance and should therefore be included as a target audience; it would significantly increase the impact and effectiveness training initiatives.

The group followed-up by presenting the measures to monitor the achievement of the above-mentioned objectives at two main levels: (1) training providers and, (2) training boards.

The group recommended that, along with providing technical assistance, the program should attempt to enhance the resources of local training institutions. In this regard, the group explored ways to equip local training institutions to be able to develop materials for training by themselves and thus reduce the reliance on international institutions over the long term. This will also help to better contextualize training materials to the local culture and conditions of each region. In doing so, the group underscored the importance of equipping a roster of qualified trainers who are able to conduct and deliver training programs to directors on the ground. Training of trainers, therefore, was deemed an essential precondition for success.

Main monitoring indicators for measuring success included: the numbers of trainers trained; the satisfaction of training recipients with these trainers; and passing rates of certification exams. Others included the number of knowledge sharing events and exchange between institutes of emerging markets, which signals progress and a dynamic created by training initiatives/projects. In addition, whether the quality of training materials has been improved in local institutes or whether it remained the same.

The group noted that the second level of indicators should monitor the impact of the training in bringing about changes to board effectiveness. As the board's performance should be enhanced after the training, performance indicators thus have to be controllable. Financial performance, in this case, is not appropriate to be used as measure of success. Other indicators that can be used as a measure of success include: oversight ability, providing vision and accountability. It was highly recommended by the group to have an instrument to measure the performance of the board before and after the training, as a way to monitor change.

TOPIC 3:
What should be in the training for non-executive directors of emerging market banks? How should they be trained?

Discussion leader: Paul Coombes, Chairman, Centre for Corporate Governance, London Business School & member of Global Corporate Governance Forum's Private Sector Advisory Group

Rapporteur: Catherine Lawton, Director, Nestor Advisors Limited

The group stressed the importance of establishing the expectations of directors and aligning them with sound governance and banking principles. The group recommended the following topics to be included training materials/modules:

- Fundamentally, what is governance and how does governance impact performance?
- Role of Non-Executive Directors. Who reviews and who approves?
- Responsibilities of the board as a whole
- Importance of the role of the chair: What difference does a good chair make?
- Succession on the board
- Skills of the board
- Dealing with conflicts in a board setting
- Company's secretary role
- What information should directors get?
    - How that information compare to what the management gets?
    - What kind of level of detail should be there?
- The role of regulators post crisis
- Set the stage for what is good governance, including how non-executive directors look at financial statements and how do boards govern themselves?

Stylistically, the group suggested including practical guides and role-playing exercises, as well as case studies (local ones preferred) in any training or training materials.

Annex 2

Financial Crisis Response Consultation
19 June 2009

World Bank Paris Office
66, Avenue d'Iéna
Paris, France

AGENDA

9:00-9:30 **Introductory remarks**

Opening remarks – *Mats Isaksson, Head of Corporate Affairs at the Organisation for Economic Co-operation and Development (OECD)*

Project overview – *Philip Armstrong, Head, Global Corporate Governance Forum*

Objectives of the meeting – *Jon Lukomnik, Consultant, Global Corporate Governance Forum*

9:30-11:00 **What were the weaknesses of corporate governance in banks that contributed to the crisis? What do non-executive directors of banks need to know?**
Discussion led by and opening remarks from Prof. Eddy Wymeersch, CESR's Chairman and Chairman of the Belgian "Commission Bancaire, Financière et des Assurances" (CBFA) & member of the Global Corporate Governance Forum's Private Sector Advisory Group (PSAG)

- Did non-executive directors know enough?
- Did remuneration policies create unintended risk?
- What are short term/long term dichotomies in banking corporate governance?
- Who serves as non-executive directors at banks?
- What do bank non-executive directors need to know?
- What level of technical expertise is needed?
- How can bank directors gain assurance in management's risk management?
- What are the right questions to ask?
- What systems need be in place?
- What information should be presented to directors?

11:00-11:30 Coffee Break

11:30-12:45 **How will the financial crisis affect banking regulations?**
Discussion led by Mr Fabrice Macé, Senior Adviser, French Banking Commission and opening remarks from Grant Kirkpatrick, Senior Economist, OECD

- What should we expect from regulations?
- What directors need to know about compliance?
- How will regulations affect risk profiles?
- How should a corporate governance training program react to periodic regulatory changes?

12:45-14:00 **Lunch and table-top discussions**

What should be in the training for non-executive directors of emerging market banks? How should they be trained?
Discussion led by Paul Coombes, Chairman, Centre for Corporate Governance, London Business School & member of Global Corporate Governance Forum's Private Sector Advisory Network

Rapporteur: Catherine Lawton, Director, Nestor Advisors Limited

Measuring Success: How do we know if we succeed?
Discussion led by Emmanuel du BOULLAY, Founder and President of FINCA & Co-founder and Director of the Institut Français des Administrateurs (IFA, French Institute of Directors)

Rapporteur: Prof. Sidartha Utama, Chairman, Indonesia Institute for Corporate Directorship

Being a director in a crisis – What to do when normal procedures don't work
Discussion led by Christoph Winzler, Member of Senior Management, Head of Financial Markets Law, Swiss Bankers' Association

Rapporteur: Laura Ard, Lead Financial Sector Specialist, World Bank

14:00-14:30 **Reports from table-top discussions - Rapporteurs**

14:30-15:30 **How do different banking business models affect risk**?
Discussion led by and opening remarks from Léo Goldschmidt, Former Chairman of the Belgian Banks Association; Honorary Managing Partner of Bank Degroof; Director, European Corporate Governance Institute & member of Global Corporate Governance Forum's Private Sector Advisory Network

- Do non-executive directors need to understand different risks in different business model situations?
- Is there anything special about what bank directors need to know in emerging

markets?
- Integrating business strategy with board risk oversight

15:30-16:00 Coffee Break

16:00-17:00 **Market Case Study: The impact of the financial crisis on Brazilian banks?**
Remarks from Mauro Cunha, Partner / Head of Equities and Portfolio Manager, Mauá Investimentos & President of the Brazilian Institute of Corporate Governance (IBGC).

17:00-17:30 **Closing Remarks**
Mr. Jon Lukomnik, Consultant, Global Corporate Governance Forum

FINANCIAL CRISIS RESPONSE CONSULTATION
19 JUNE 2009

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66, Avenue d'Iéna
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