

Bank Boards: Challenges of Interfacing with Shareholders, Supervisors & Management

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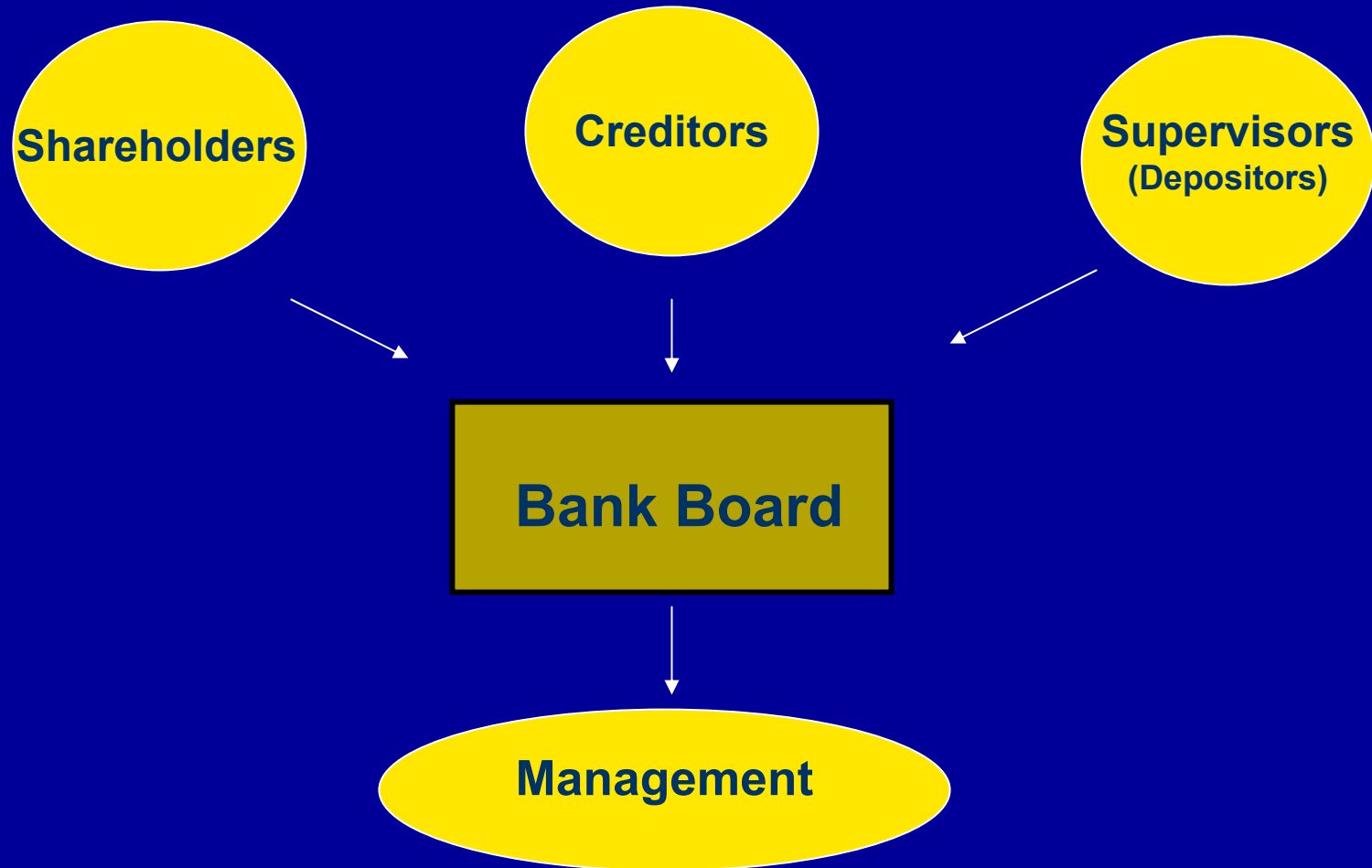
SUERF Seminar

Corporate Governance in Financial Institutions

Central Bank of Cyprus

Nicosia, 29-30 March 2007

Boards Have A Pivotal Role in Risk Oversight...



...Managing Multiple Stakeholders

Directors need to:

1. Understand their fiduciary responsibilities vis-à-vis shareholders
2. Ensure market signals are acted upon
3. Understand how bank supervisors look at financial stability
4. Define their engagement with management

Responsibilities to Shareholders

- To deliver sustained valuation growth through judicious management of business opportunities, respecting all stakeholders
- Particularly important in financial sector, given its allocative functions of savings to promising investment opportunities
- Extending access to financial products to broader segments of the population

Managing Multiple Stakeholders-2

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Market Discipline

- *“Market prices are a powerful mechanism to summarise information about relative risk/return profiles. Market forces can raise the cost or restrict the volume of funding for unattractive activities. Together with the ultimate threat of the demise of the enterprise, these mechanisms can deter risk-taking” .* - Andrew Crockett, (Fmr) BIS General Manager

Market Discipline: Board Involvement

- Quantity and price changes should prompt management to cut back risk exposure
 - Management may lack incentives for quick action
- Board of directors must lead risk re-alignment
 - In response to market signals
 - To protect shareholders' franchise value
- Board effectiveness helps supervisory actions

Managing Multiple Stakeholders-3

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The Supervisory Perspective

- Risk management considerations are central in today's financial stability architecture
 - Internal governance is a key regulatory aspect
- Board understanding of and involvement in risk management is key to supervisors' validation of risk models

The Supervisory Lenses

- International Standards
 - Revised Core Principles for Bank Supervision (Oct 2006)
 - Also: Enhancing Corporate Governance for Banks (Feb 2006)
- Most Relevant Core Principle
 - #7: Bank supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board oversight)
- Most Relevant Corporate Governance Principles
 - #2-3: Board of directors should approve and oversee the bank's strategic objectives & set and enforce clear lines of responsibility and accountability

The Supervisory Lenses (2)

- Other Corporate Governance Principles
 - #6: Board and senior management should use auditors' work
 - #8: Board and senior management should understand the bank's operational structure
 - Supervisors should bring to the board of directors' and management's attention problems detected through supervisory efforts

Supervisor Main Interface: Board or Management?

Managing Multiple Stakeholders-4

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Board Relationship with Management

- Key aspect for fulfilling its oversight responsibility to shareholders, creditors and supervisors
 - Sharing informational benefit of executive powers
- Requires clear demarcation between matters requiring Board involvement and those delegated to management
- Built on robust processes and functional skills
 - Board must be capable to keep management accountable

A Key Platform: Board Agenda

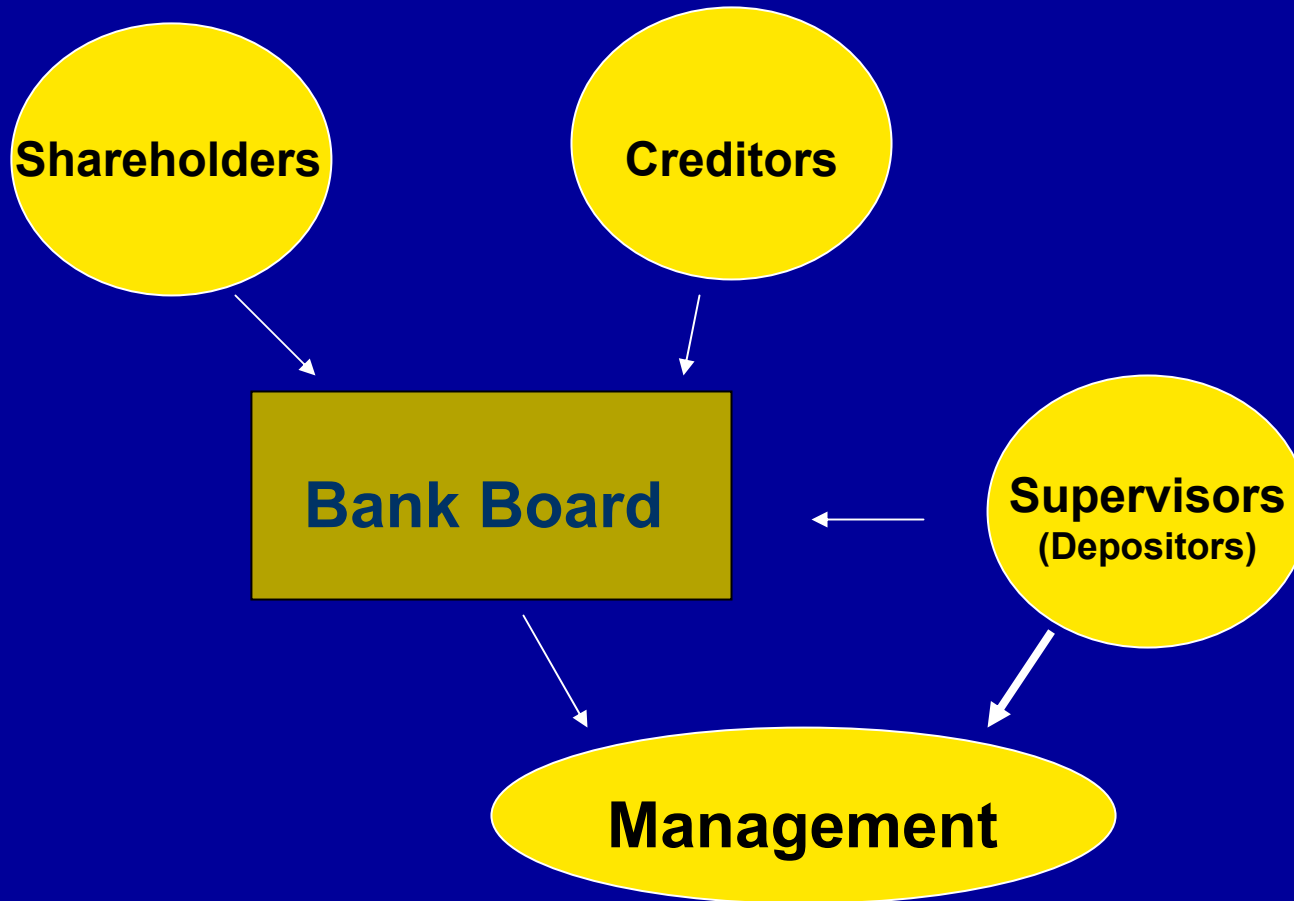
Active Role

- Strategy Setting
- Key Business and Risk Management Decisions
- Interface with Internal Control Functions and Bank Supervision
- Keeping the Pulse of Management and Staff Views

Oversight Role *Overlap with supervisors*

- Strategy Monitoring
- Comprehensive Risk Assessment
- Review of Risk Management Actions
- Review of Market Conditions
- Review of Risk Parameters

Are Supervisors Board-Friendly?

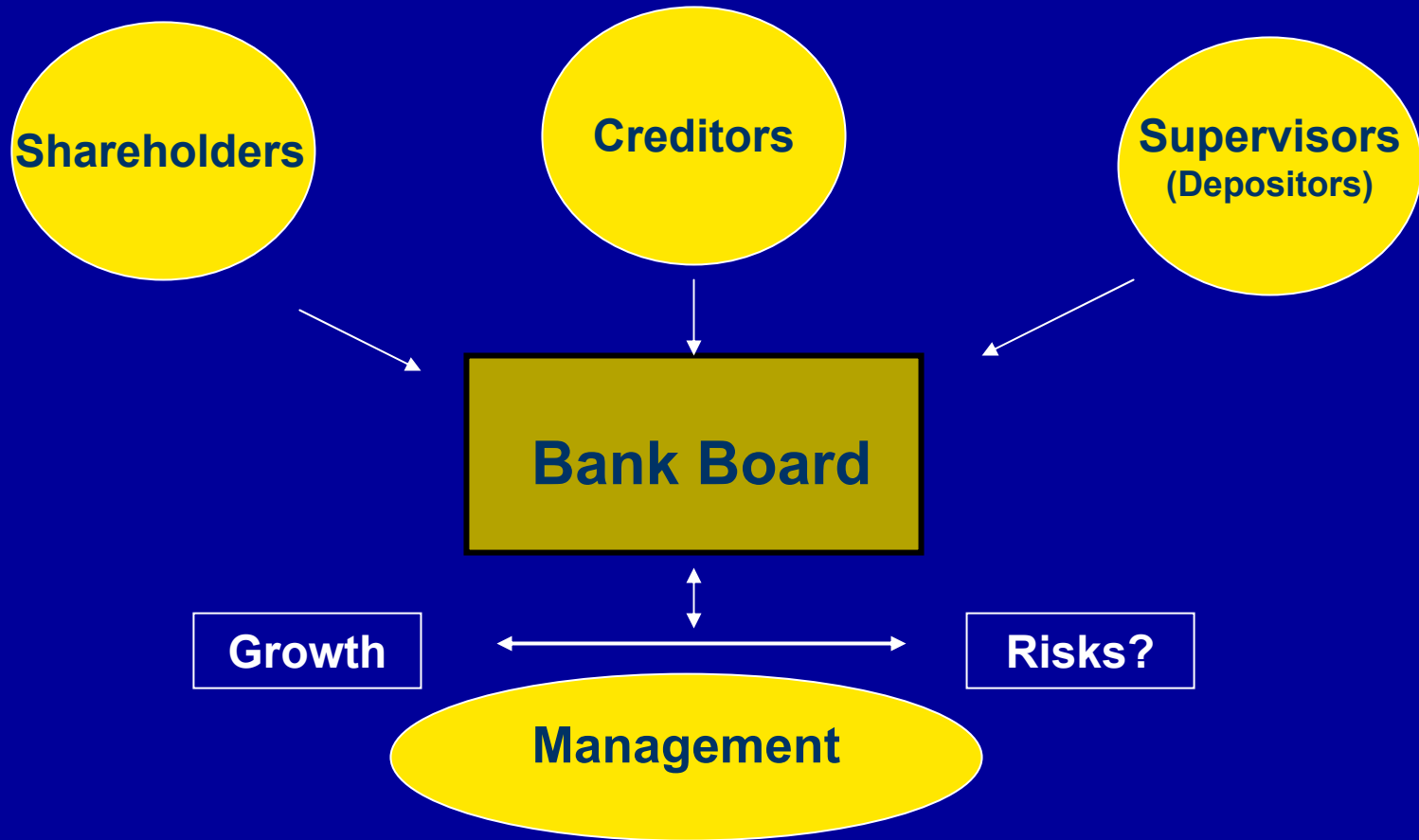


Impact on Board Monitoring Incentives

How To Increase Board Effectiveness?

1. Is the increasing emphasis on stronger corporate governance of banks having an impact on supervisors' risk assessments?
 - Where can the biggest pay-offs be found?
2. Is it conceivable for supervisors to delegate more supervisory functions to Boards?
 - Or can Boards be at most a useful “spare” tire?
3. Should supervisors build more pro-actively risk management skills of board members?
4. How can shareholder incentives for stronger bank governance be further expanded?

Successful Board Trade-Offs Management



Can Have Significant Public And Private Benefits¹⁷

Conclusions

- Boards are responsible for managing both the upside potential and the downside risks
 - To provide unitary oversight to management, boards need to manage complex relationships with several stakeholders
 - Incentive-compatible regulations are necessary to mitigate risks of dysfunctional behaviors
- Board relationship with supervisors is critical
 - Supervisor data and risk analysis need to be incorporated in board processes
- Supervisor extensive interface with management weakens Board oversight role
 - Expanded role for Audit Committee?