Finance Watch

Making finance serve society

Finance Watch response to the BCBS consultation on corporate governance principles in banks

Brussels, 9 January 2015

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Finance Watch welcomes any attempt to improve banking conduct therefore we appreciate the Basel Committee's work in this area. We are supportive of the objectives of the revised principles of corporate governance for banks and we believe that the document represents an important development in the area of risk governance. The suggested "three lines of defence" model is a useful framework for more effective risk management. However, banks have a tendency to adapt their risk practices to suit the needs of their business (size, culture etc.) and we are wary of any steps that may repeat the pre-crisis overreliance on internal models and external ratings.

In a market economy, the fundamental question arises to what extent one may intervene as a legislator in the internal business processes of a private company and whether or not the proportionality between society and private sector interests are safeguarded. One could even question the need for special governance rules for banks as it could signal a lack in efficiency in current bank regulation, banking laws and bank supervisory systems.

On the other hand, having in mind the specialist nature of banks, their key function of providing bank credit money and their role as financial intermediaries, one could say that corporate governance principles for banks should protect the interests not only of shareholders but also depositors, creditors and other stakeholders. Governance rules might also reflect the need for bank managers to ensure the solvency of their institution and the stability of the financial system as a whole.

Finance Watch welcomes the opportunity to share certain considerations on the current deficiencies of the banking sector and corporate governance:

A. Risk appetite
   Corporate governance is traditionally viewed through the prism of agency theory, which suggests that a firm's ownership structure determines its shareholders' capacity to influence risk-taking. Finance Watch believes that the objectives of risk taking, long terms investments and returns need to be aligned. We acknowledge that recent reforms have added resolution tools and increased banks' loss absorbency, including the bail-in principle to make sure that the right stakeholders (shareholders and creditors) are responsible in a bank insolvency. The development of the resolution regime shifts the losses from taxpayers to stakeholders and supports the point that proper regulation rather than corporate governance reform is crucial for safer regulation. While this provides a degree of alignment, the question remains open, especially in case of TBTF banks, if the bail-in will be used. In a crisis, policymakers would face a trade-off between placing losses on a narrow set of taxpayers today (bail-in) or spreading that risk across a wider set of taxpayers today and tomorrow (bail-out). In addition, as TBTF banks' funding is mostly provided by other financial institutions, they are highly interconnected. **Hence, transferring the losses via bail-in tools would contaminate other banks and risk creating a domino effect. Actions to avoid this would lead once again to taxpayers absorbing the losses.** Therefore we question the added benefit for society of having further rules and norms for governing TBTF banking business models when it is this business model itself that poses a risk to the monetary system and the real economy. Hence, if the current business model of banks is so dangerous and risky, why

not consider regulatory solutions that address the model rather than setting norms and standards through governance rules. If banks were forced by law to reform their business models and their corporate organization in order to rescale their risk-taking, then the need for specific governance rules for banks would be much reduced.

B. Risk management

Good corporate governance in our view means that banks understand and maintain the right levels of risk. Therefore we especially support the recommendations regarding the risk committees, independent Chief Risk Officer and risk appetite statement (RAS). We believe that these would help to oversee actual risk exposures and advise the board on risk management strategy. However we would also like to point out the overreliance on mathematical models for measuring risks. As the models tend to be based on simplified descriptions, aggregated data and many assumptions, their usefulness in predicting future events is limited. Therefore we would like to underline the necessity of prudent subjective assessment by qualified, responsible individuals.

C. Structure of banking groups

Shortcomings in the governance of large financial groups have highlighted the potential for widespread systemic crises to occur. The effectiveness of corporate governance is also reflected in market discipline. Banks in pursuit of profit can easily use gaps in legislation to expose themselves to risk without incurring regulatory consequences. The BCBS guidelines state that the implementation of the principles should be proportionate with the size, complexity, structure, economic significance and risk profile of the bank or the group. Therefore the complexity of SIFIs' structures should be taken into account in addressing their impact on national and global financial stability.

Banks' complexity, risk composition and asset structures have made it more challenging to implement corporate governance. We agree in general that the principles presented in the BCBS principles could enhance corporate governance in banks. The reviewed principles underline the major role of the board and risk governance, risk appetite and compensation. In the increasingly complex and interconnected business environment, it could have a positive impact to stress the importance of proper risk management.

Finance Watch believes that the financial sector, while somewhat improved, still faces problems from TBTF institutions. No corporate governance model can work when the principal actors face severe limitations in their knowledge and understanding of risk due to objective factors, such as complexity, or lack of transparency in financial transactions.

There is also the question of incentives. Corporate governance standards must work alongside commercial incentives and these may sometimes conflict. As an illustration, pressure to take on – or exceed - the maximum permitted leverage might conflict with principles of responsible governance. So even if managers can know and understand all the risks in a complex organisation, their responses could be weakened if the commercial incentives bound up in the organisation's structure are hard to resist.

We fear that the efforts to improve corporate governance may not achieve the optimal desired results in addressing moral hazard unless the structure of the banking sector is itself reformed and banks becomes smaller, less interconnected and easier to manage. Bank size, structure and complexity have been important factors in cases of weak governance (short termism, insider rent-seeking and inadequate shareholder/stakeholder monitoring).

Finance Watch notes that none of the legislation adopted since the crisis aims to re-focus the banking sector on serving the needs of the real economy. The new regulatory framework takes the banking system as it is, with its TBTF business model and its focus on transactions and short-term fee-based business. **It does not address the shift of megabank activities away from the kind of relationship-based, long-term oriented banking that society needs for sustainable, non-cyclical financing.**

We therefore encourage the Basel Committee, when revising its corporate governance principles for banks, to consider the following:

1. Adding structural reform to the list of measures for addressing the TBTF problem and improving corporate governance.

   The major benefit of adding structural reform to corporate governance improvements would be a reduction of the conflicts of interest common in the financial service industry and the nearly unlimited liability that big banks may incur because of those conflicts when senior managers fail to understand the complexity and risks of their group's portfolio. Finance Watch believes that the corporate governance of banks should not be reformed without seeking reforms to the bank structures that affect governance incentives within large and complex banks. We believe that the foundation of good corporate governance in the financial sector is competition between smaller, less complex and less interconnected banks.

2. Limiting the reliance on internal models or ensuring the consistency and soundness of risk weights calculated through internal models.

   Proper risk management is essential for banks' survival and financial success. We believe that the role of risk management is not to reduce bank's total risk per se, but to identify and measure risks taken, aggregate these risks in a measure of the bank's total risk, enable the bank to eliminate, mitigate and avoid bad risks, and ensure that its risk level is consistent with its risk appetite. It is therefore important that risk metrics are reliable.

3. Paying more attention to macroeconomic risks

   While significant work has been done since the crisis to ensure the soundness of individual institutions, much remains to be done on a macro prudential level to address systemic risks. Finance Watch recommends that prudential rules such as capital requirements should take more account of individual banks' contribution to systemic risk. Together with limiting the creation of pseudo safe assets, curbing procyclicality and curbing the use of securities financing, this should help to make private backstops more

robust, internalise negative externalities and reduce moral hazard. Governance rules should also take account of a bank's externalities.

4. Long term financing

Some types of banks may try to boost short-term returns on equity by favouring short-term activities and fragile funding structures at the expense of longer term lending.

This is not a desirable outcome from a financial stability or a society point of view. Regulatory measures might include a redesign of liquidity ratios, and steps to internalise the negative externalities of securities financing, such as a minimum haircut for all securities financing transactions or capping the re-use of collateral.[1]

We believe that corporate governance principles could also be used to help firms establish medium and long term strategies, to align them with the institution's goals and disclose them to shareholders and supervisors.

[1] See Finance Watch's December 2014 position paper on long term financing, securitisation and securities financing for further details.