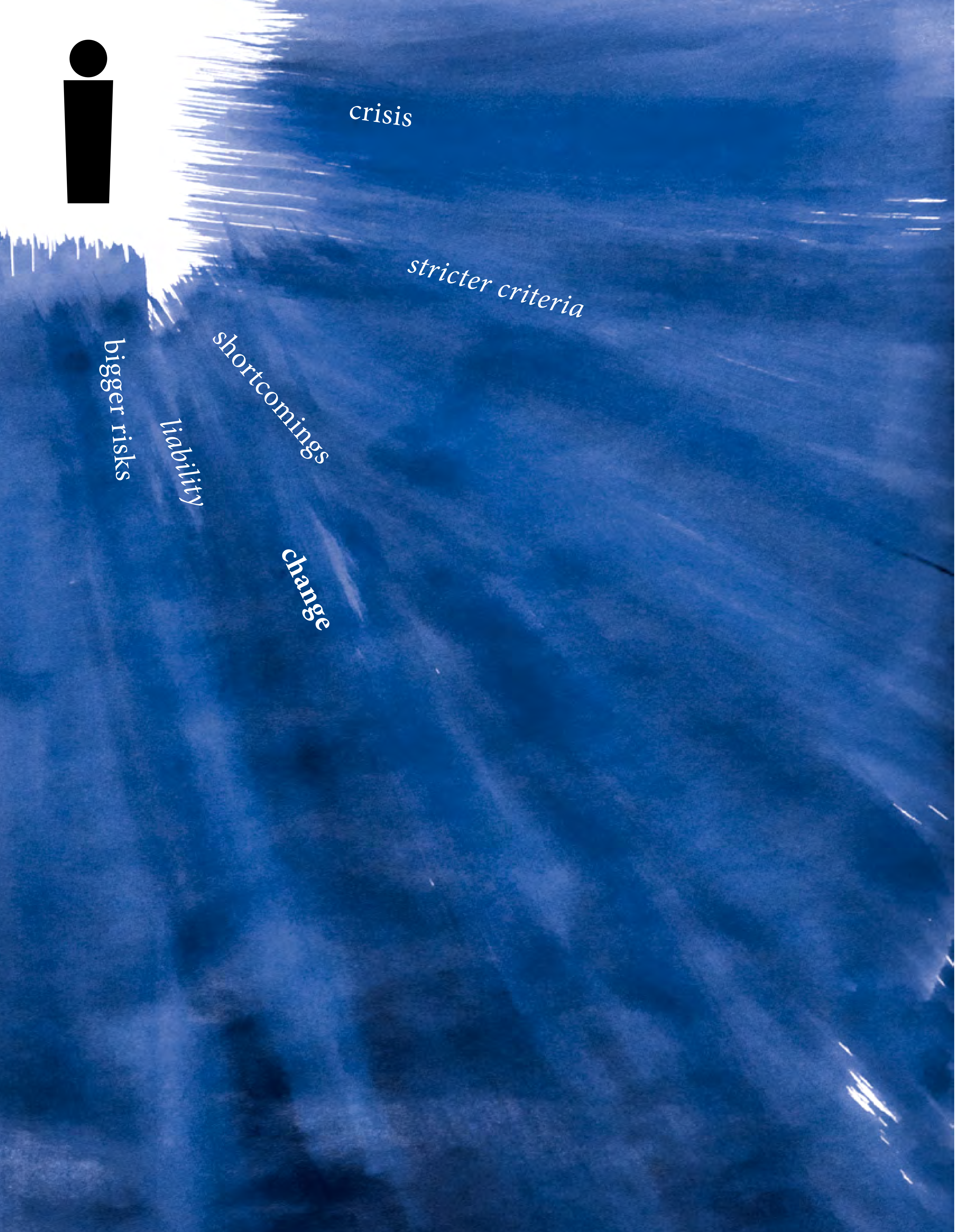

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Time for a Change?

Revisiting the Role of Board Directors of Banking Institutions

There is little doubt these days if any that boards of large companies, regardless of the industry sector, work differently compared to only a few years ago. Intensity and professionalism on the part of board directors have increased in order to properly deliver on their fiduciary duties.

Reshaping the bank's playing field

The most obvious case in point for this surge of intensity has been the banking sector for very obvious reasons. There is broad agreement that the recent financial crisis unveiled a number of serious shortcomings such as the lack of understanding as to complex financial products, lack of time and commitment to the job and, in a number of cases, a lack of independence from senior management and sometimes a lack of willingness to challenge executive management.

Over the last few years, the resilience of the banking sector has greatly improved for a multitude of reasons, first and foremost because the capital buffers of banks have increased significantly, regardless of geography or type of bank.

Regulators and supervisors are more or less finalizing the reshaping of banks' playing field. Whether this will be a level one or not remains to be seen. Increasingly, other factors are coming into play, so-called soft factors such as "fit and proper" issues for senior officers or a sharp increase in fiduciary duties of board directors. Expectations on the part of regulators when framing the role for "non-executive chairmen" are close to a full-time job. Senior independent lead directors are equally expected to devote very serious amounts of time to the bank where they serve.

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The wind of change in supervisory boards

In this context the traditional dual structure of German corporate governance creates a serious fault line opposing traditional corporate law and a more recent supervisory practice particularly since the inception of the Single Supervisory Mechanism under the roof of the ECB. Whereas the former typically relegates German supervisory boards to a more passive and reactive role, hence waiting for management to supply information and seeking interaction and asking for limited time commitments only, modern supervisors not only in New York and London, but also in Continental Europe call for (supervisory) boards to provide serious and much more comprehensive input at a number of levels. Among the most pertinent areas are audit, risk and, more recently, compensation for so-called risk takers, who meanwhile are regulated with utmost granularity. Needless to say that corporate strategy should be at the pinnacle of interaction between boards and executive management, but increasingly regulation is sitting squarely at the center of board activities. Another example, risk committees are expected to assess the adequacy of interest and risk margins in individual cases of credit business. Also, the most senior members of supervisory boards are obliged to be interviewed in remarkable detail by supervisors as to their activities. The areas where intense scrutiny on the part of boards is prescribed in detail are growing rapidly and force board members to devote ever higher amounts of quality time to a single board assignment. It comes as no surprise that regulators have curtailed the number of board seats any one individual can hold beyond the one on a bank board.

Stricter criteria, bigger risks and more liability

Appointments of new board members are meanwhile scrutinized by supervisors in the form of ever more demanding "fit and proper" tests. This also includes banks that are not publicly listed but rather shielded from institutional investors. Board members' quality and understanding of the business as well as their willingness and ability to devote time to the task are increasingly scrutinized.

The leitmotif supervisors are applying is one of elaborate checks and balances among various stakeholders, with supervisory boards, internal and external auditors, supervisors themselves, but also investors and rating agencies providing input to keep executive management on its toes. Boards are increasingly made liable if something goes seriously wrong. In the banking sector, the general public wants to see individuals held accountable for mistakes of the past and, if possible, even put in jail, certainly in Germany. Even if the likelihood of being convicted may be relatively small given that the burden of proof remains on the shoulders of the prosecution, it is highly onerous to be tried in court for many weeks and to be quickly convicted in the court of public opinion where the bar is much lower. Variations of this tune can be observed in a number of countries and lead to serious consequences.

ANY MARKET FAILURE MIGHT EASILY RESULT IN A REGULATORY TSUNAMI.

On the one hand, this facilitates efforts to try to blackmail senior bank officers. The perhaps more serious consequence is an increasing reluctance to serve on bank boards. As described, the onus of such a commitment has increased markedly whereas corresponding compensation has not kept up.

It is in fact somewhat inconsistent to call for better qualified boards of directors and to request a much higher time commitment while caring little about adequate preconditions for recruiting such individuals. I would not be surprised if over the next few years we witness a certain exodus of well-qualified board members.

Other sectors should prepare the umbrella before the rain…

The story up to this point may sound like a very bank centric one with little or no relevance for other industry sectors. However, other areas of the economy are also increasingly subjected to very high and very granular regulation, the energy sector as a case in point. Especially in Europe, any market failure, either real or only perceived, might easily result in a regulatory tsunami with external auditors and boards of directors at the cutting edge of additional burden as well as additional and increased liabilities. A number of European directives already show the way, the selection and rotation of external auditors as an example. Boards and audit committees are commissioned to rotate auditors among a small group of qualified professionals while observing strict requirements with regard to compatibility of annual audit and consultancy service. Any procedural mistake may result in personal fines.

Hence, it might be a timely idea for directors outside the financial sector to take a long, hard look at the changes unfolding in the banking sector. To adapt Einstein's famous quote about Switzerland: It will be happening in other industries as well, even if only 50 years later.