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In Search of the Silver Bullet: A discussion on Corporate Governance

Foreword

The recent credit crunch accompanied by serious difficulties and the collapse of a number of banks such as Northern Rock in the UK, Fortis in Belgium and Lehman Brothers in the US have placed the Corporate Governance systems of modern financial institutions under closer scrutiny than ever. Lapses in the personal and professional integrity of banks' top executives, excessive risk-taking and distorted incentives have undermined confidence in financial markets and led to a substantial erosion of trust in the modern financial system. As a result, investors and regulators are putting pressure on banks to improve their remuneration policies, rethink their relationships with shareholders and strengthen corporate boards as part of a wide ranging reform of Corporate Governance.

There is a natural tendency however, to leap to conclusions about what needs to be fixed in banks with regards to Corporate Governance before understanding why it all happened in the first place. To find the true sources of weakness in the Corporate Governance of the financial industry, there is a need to take a longer-term and more holistic view on the recent evolution of the banks' governance mechanisms, their risk management functions, the investor relationships with institutional investors and the role of regulatory bodies such as the Financial Services Authority and Bank of England.

A comprehensive analysis of multi-faceted governance problems in financial institutions is an enormous task that requires a concerted effort by academics, practitioners and the regulator. This paper represents one of the first attempts to provide a clear, balanced and holistic overview of Corporate Governance in financial institutions by bringing together and capturing the views of various participants in the governance mechanism, such as non-executive directors, members of the investment community, bank risk managers and regulators. The paper provides a valuable and useful platform for future research and discussions around "good governance" principles in financial institutions as outlined in a number of recent analytical reports including Sir David Walker's *Review of Corporate Governance of the UK Banking Industry* published on July 16th 2009.

Professor Igor Filatotchev

Director, Centre for Research on Corporate Governance
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Background

On June 25th 2009 BNY Mellon and Cass Business school co-hosted a conference to discuss "Can Corporate Governance Make a Difference at Financial Institutions?".

Conference Speakers:

Opening Remarks

Richard Gillingwater, *Dean, Cass Business School*

Conference Co-Chairmen

Prof. Igor Filatotchev, *Faculty of Management, Cass Business School*
Dr. Peter Hahn, *FME/ESRC Fellow, Faculty of Finance, Cass Business School*

The Views of Government & Regulation

Rt. Hon. John Thurso, *MP, Treasury Select Committee, Commons*
Dr. Thomas Huertas, *Director, Banking Sector, Financial Services Authority*

The Views of Shareholders

Mark Burgess, *Head of Active Equity Investment, Legal & General*
Leon Kamhi, *Commercial Director, Hermes Equity Ownership*
Dr. Daniel Summerfield, *Head of Responsible Investment, Universities Superannuation Scheme*

Risk Communication with the Board

Ann Cairns, *Managing Director Alvarez & Marsal and Head of the Financial Industry Advisory Group in Europe*
Brian Rogan, *Chief Risk Officer, BNY Mellon*
Stephen Roughton-Smith, *Group Credit & Business Risk Director, Lloyds TSB*

The Views of Directors

Sir Ron Sandler, *Chairman, Northern Rock*

Commentator Overview

John Plender, *Financial Times, Chairman, Quintain plc*

HM Treasury and the Financial Services Authority (FSA), fund managers and pension funds, risk directors, non-executive directors and the media all contributed their perspectives and insights. Active participation from a diverse audience ranging from bank managers and asset managers to corporate governance professionals and academics contributed to the overall exchange of views and opinions on this controversial topic.

Bank failures and the concomitant financial crisis have placed Corporate Governance under closer scrutiny than ever. Was a failure of governance, in fact, a root cause of the crisis?

There was general agreement that there was "a clear failure of Corporate Governance as part of the failure of the overall system," but few people seemed to think this was the only cause of the crisis, or indeed the major cause. Discussions centred on the future, and the role of Corporate Governance in strengthening the financial services industry. Themes explored included:

- Regulatory Authorities: is new policy generation the answer?
- What makes non-executive directorships effective?
- Are institutional investors really focusing on Corporate Governance?
- Getting remuneration right.
- Risk expertise in the Boardroom today.

Regulation in the Financial Industry

Over the past two years the UK Government has given banks an unprecedented amount of support. As a result, UK Financial Investments Ltd. (UKFI) was created on November 3rd 2008 to manage the Government's investments in financial institutions, which include¹:

- Royal Bank of Scotland (57.92 per cent through ordinary shares)
- Lloyds TSB/Halifax Bank of Scotland (43 per cent through preference shares)
- Northern Rock (100 per cent since February 2008)
- Bradford & Bingley (100 per cent of non-retail; the retail business was bought by Abbey on September 29th 2008)

The price of this support amounted to around 47.5 per cent of UK GDP (*source: IMF*). It is natural, therefore, that there should be calls for closer regulation and oversight of the sector to prevent a recurrence of systemic failure on this scale. "The taxpayer will never accept such a calamity again", said one speaker.

As a result, the FSA is offering the banks a stark choice: "governance or government". In other words, be governed or government-owned.

However, the relationship between regulation and governance is more complex than the average taxpayer might assume. Regulation sets the framework in which governance operates; it establishes rules and principles. Governance is about selecting the right people, managing relationships, understanding, interpreting, and implementing those rules and principles, and ensuring that the structures of firms and Boards are responsible and effective.



Regulators themselves are not infallible: "It is a weak system if all depends on the regulators' judgement," commented one speaker. It is also difficult to establish regulation that promotes common sense and strength of character of non-executive and executive directors. Boards need to be able to exercise unencumbered judgement and executive directors need to be able to strategise in innovative ways so long as the short and long term risk implications are well understood by both management and the non-executive directors: "The more you regulate the less thought you get."

This frame of thought probably contributed to regulators' notably light touch in the years before the crisis, when many in the financial services industry demonstrated a clear aversion to additional rules and closer supervision. Indeed, the FSA even reduced its staff in 2005/2006. As a result of recent events, however, this aversion to closer scrutiny by regulators seems to have been forgotten. At the conference, it was interesting to hear institutional investors voice the thought that the regulatory bodies should have intervened earlier. Many now look to blame the regulatory bodies for failing to act appropriately or more stringently. It is not surprising that following the collapse of the UK financial market, the tripartite regulatory structure is under review with the Conservative and Labour parties each having their own separate views on its future.

¹ As of August 25th 2009.

During the conference there was still uncertainty about the conclusions that Sir David Walker would draw in his *Review of Corporate Governance of the UK Banking Industry*. In his consultation paper published on July 16th ², Sir David makes a series of 39 recommendations on Corporate Governance Standards in financial institutions which, if followed, would in the main bring all firms' governance up to the standards of the best in the industry. The paper challenges remuneration policies, calls for greater responsibility on the part of shareholders, insists on greater risk governance, suggests greater empowerment of non-executive directors and supports a strengthening of the Chairman's role, all of which topics were discussed with great enthusiasm during the event sponsored by BNY Mellon.

The Walker consultation paper along with the review of the regulatory structure, in particular the relationship between the FSA and the Bank of England, could significantly change the landscape of the financial services industry in the UK. Chancellor Darling's new council to oversee financial stability will most probably impose tougher regulation on financial institutions in order to achieve greater consumer protection. What the new regulatory landscape will look like is still in question as the Conservative party and the current Government dispute their different views on the tripartite regulatory regime comprising the FSA, the Bank of England and the Treasury. In particular, it is the future of the FSA and the authority of the Bank of England as well as their level of interaction that will be analysed.

Corporate Governance

Non-Executive Directors – Role, Aptness and Stakeholder Interaction

... the "idea that . . . non-executives suddenly turn themselves from people who had no impact" into people who can affect those running institutions was "an illusion".

Bank of England Governor Mervyn King quoted in the *Financial Times*, June 25th 2009

At the conference the composition of Boards was a recurring subject. The systemic risk posed by financial institutions makes the selection process of Non-executive Board members for larger financial institutions a matter of public interest. Views varied widely on whether industry experience was crucial or not, whether age plays a role and how many Board memberships should be held concurrently by one person. It was suggested that non-executive directors with several Board memberships spend less time developing an in-depth understanding of the more complex business transactions in individual financial companies.

Boards can suffer from a "herd instinct" and from complacency — both of which can have equally damaging effects. The glaring fault of the Board of Lehman Brothers, according to one speaker, was that they thought they "knew it all".

Some people expressed a belief that there should be a mix of bankers and non-bankers: a Board needs a diversity of opinion. There was, however, agreement that less experienced management teams need the benefit of access to the experience and opinions of more seasoned people on the Board.

² Following the end of the consultation period on October 1st 2009, a final version of Sir David Walker's report will be issued this November.



There was general agreement that, in difficult times, continuity of service of a senior Board member will be more important than strict adherence to the normal nine-year term of office rules. Also, the practice of 'promoting' the Chief Executive to the role of Chairman, which had been rather frowned upon as potentially causing a conflict of interest, should be allowed under certain circumstances. Standard Chartered and HSBC are examples

of this point. Sir David's paper advocates the loosening of the Corporate Governance requisite that Chief Executives not become Chairmen, and recommends that non-executive directors make a greater time commitment and be more ready to challenge and test proposals put forward by the Executive Board.

There clearly remain a large number of questions over the role of the non-executive members of the Board. What do we expect them to do? How do we expect them to behave? Should they be acting as the friends and colleagues of the executive directors, a practice that was referred to as "mixed bathing" by one of the participants, and not fostering a challenging environment? Or should, indeed, the relationship be adversarial, taking as an example the more formal Treasury Select Committee model of questioning? Should non-executives take the same approach or continue the balancing act of remaining collegiate without compromising their objectivity? It is clear that a more objective approach should be adopted and that collegiality should only go so far. Certainly, as far as participants at the conference were concerned, non-executives are not expected to out-manage the Executive Board. They are not there to second-guess every decision but rather, according to one speaker, they are there to offer oversight, particularly in the areas of "strategy (including M&A), remuneration, and risk." As recommended by the Walker consultation paper, Non-executive Boards should challenge and understand the risk their respective institutions are or could potentially be exposed to by strengthening their risk, audit and remuneration committees.

One of the directors present did express the opinion that the Board's principal function is to hold management to account. "It is naive to assume they can add strategic value". Other participants, however, did expect the Board to have a "true grip of strategy" and the ability to set parameters within which the executives should operate. Even more importantly, they argued that the Board should accept responsibility for risk.

Shareholders – Engagement and Expectations

The typical diversification of investment portfolios amongst institutional holders results in their holding a large number of different equity securities. In the case of index investors, there is very little choice in terms of whether or not to hold a particular security.

In theory, institutional investors develop relationships with the companies they invest in at a senior management level, the principal relationship being with the Chairman or Senior Independent Director.

In reality, the component of institutional management fees allocated to Corporate Governance is minimal, and this ultimately has an impact on the amount and effectiveness of interaction with their portfolio of companies. The institutional investors present admitted that they did not regularly attend Annual General Meetings due to lack of time, resources, and financial constraints. Indeed, their focus was and remains the maximisation of investment value. They clearly rely on the regulator to intervene when a company is embarking on high risk strategies.

Indeed, participants at the conference complained that “we had conversations and voiced concerns that were either robustly defended against or ignored” by management of some of the entities that later ran into difficulties. These “conversations” were typically held in private to achieve a higher level of engagement compromising, however, the institutional investors’ ability to take advantage of a collective view or derive confidence from hearing others express doubts or ask questions. As it is, investors tend to be persuaded by the Executive Board. As one speaker put it, “When you have a very articulate CEO, supported by the full Board and advisors all supporting the same course of action, it is very difficult to resist.”

“What more could we have done?” the investors asked. They clearly believed that the FSA and regulators could have done more, pointing out that the regulatory bodies did not intervene even when leverage reached a multiple of 75 for one banking institution. We “need a proper regulatory regime that looks after our interests.”

Should institutional investors accept more responsibility? Sir David suggests that investors should sign up to a set of "principles of best practice in stewardship" and recommends the creation of a lobbying panel comprising up to a dozen of UK's leading institutional investors, suggestions that were the subject of animated discussion. Investors at the conference wanted more engagement by the non-executives, and more authority to challenge strategy. There was recognition of the need to develop scepticism themselves, not to depend on the Government, and not to accept at face value everything they are told by management. They could work more effectively in coalitions and one of the key takeaways was to promote more communication amongst the more prominent institutional investors. Above all, they agreed that the quality of their communication with the companies needs to be improved. They need to know not just about the numbers and business decisions, but about who is guiding the risk strategy of the company. As one speaker said, “We know about someone’s track record, but we don’t know much about them as people.”



Risk and Reward

One area in which stronger regulation could make a difference is in governing the balance between “sales as the accelerator and risk as the brake”.

In response to the inadequacies of financial institutions’ current remuneration policies, the FSA published a Draft Code of Remuneration Practices early in 2009, a final version of which will come into force in November 2009.

It is perceived that the current policies encourage and reward risk at an individual level. By the time you get to a senior role, however, your basic needs have long since been met. Once money is no longer linked to getting by, it loses its gravity. If you construct a system that incentivises people to make a lot of money quickly and then leave, then long-term risk is no longer a factor consideration.

Furthermore, financial institutions have been willing to take greater risks, because they believe that there is a safety net if they fail: “They reckon they’ll be bailed out if they get in trouble,” as one speaker put it. “Management and shareholders (enjoyed) unlimited upside, limited downside” due to a “perceived ongoing public safety net.”

The Walker consultation paper addresses remuneration with regards to both transparency and long-term incentive schemes. Remuneration committees are expected to balance short and long-term risks with short and long-term incentive schemes, requiring a greater understanding of risk by the Non-executive Board as well as a greater remit with regards to remuneration. In fact, Recommendation 35 specifically states that the remuneration committee “should seek advice from the Board risk committee on an arm’s length basis on specific risk adjustments to be applied to performance objectives.”

So what did participants to the conference think would be a better system?

There was consensus around the idea of remuneration policies that are balanced and “promote effective risk management”. At the far end of the spectrum it was even suggested that banks should be run from the “perspective of 1) depositors; 2) shareholders; and 3) employees” as opposed to employee remuneration being first. Furthermore, “a minimum risk-adjusted return to shareholders is needed prior to deciding what goes to bonuses”. Remuneration has to be put into “perspective”, should “promote effective risk management”, and be aligned to the long term, not just to sales. There was a general disapprobation of the idea of paying bonuses upfront. It was felt that bonuses should be paid for performance, which was defined as “generating value”.

So how do you achieve the ‘holy grail’ of an effective, long-term incentive plan? One possibility suggested was a reward more closely linked to share price. Virtually all or the majority of the incentive could be paid in shares with lengthy restriction periods.

Rather than the “toxic cocktail” of paying bonuses upfront, they should be paid for long-term performance, which “generates value for the shareholders” while being “consistent with the bank’s obligation to manage risk effectively”.

Valuation and Metrics — Shifting Concepts and Values

Leverage and the nature of funding have become central issues for financial institutions. Since 2002 typical gearing has increased in some banks from a multiple of between 15 and 25 to 55 and, in places, 77 just before the crisis. Ever-increasing loan-to-deposit ratios also point to undesirable dependence on wholesale funding.

Before the crisis the investment community was aware of increasingly higher leverage but this did not appear to cause concern. Ultimately this led to a lethal combination of increasing complexity and leverage in the market.

At least partly responsible is an over-reliance on earnings per share (EPS) and return on equity (ROE) by rating agencies, analysts and shareholders as a measure of a financial institution’s performance. In the past, EPS and ROE were major factors in determining senior management remuneration. At the same time, until the crisis, it was overlooked that return on assets (ROA) had grown only marginally and dismally in relation to the change in the risk profile of the balance sheet. Focus now remains on capital adequacy. In addition to Tier 1 capital, the tangible common equity ratio (TCE), which excludes preference share capital and all intangible assets, is now seen as a more conservative measure of capital adequacy and a better indicator of a financial institution’s leverage as it measures all the assets a company would have should it be forced into liquidation. More conservative capital adequacy ratios set by the regulators serve to create “more distance between shareholders and taxpayers”.

Risk Systems — Overview, Analysis, and Awareness

One speaker declared that “The whole system is where it is because of a failure to appreciate, manage, and price risk.” Many agreed with the assumption that there is a “risk-taking culture” within the financial services industry – yet a Chief Risk Officer asked, “Where’s the evidence?”

According to the risk officers, risk management should be driven by two main philosophies: transparency and what shareholders want. The key is communication. It is critical for Chief Risk Officers to understand the risk of the underlying businesses, to have respect from both peers and management: “You can have the best risk management in the world, but if the Board doesn’t listen, it won’t work,” said one speaker.



Sir David's Recommendation 24 concurs with the view that "Chief Risk Officers should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units". The Chief Risk Officer needs to develop a close relationship with the non-executive audit and risk committees. He or she should encourage tutorials and host Q&A sessions so greater transparency and appreciation of the risk behind the business can be attained.

One panellist described his own approach to communicating with the Board: “Think of the Board as there to help you, but deliver without the jargon. Tell them the risk/reward; don’t just try to look good — if there’s no risk there’s no reward; and be dogmatic regarding risk appetite.” Communicating is not just “selling”. Using questions and answers to test engagement and understanding by the Board was one method recommended. An Executive Summary which explains the risk component as simply as possible was also recommended. “If we have a product that we can’t explain in laymen’s terms, what are we doing with it?”

Trends and Scenarios

The conference yielded a variety of new ideas and suggestions:

Contingent capital requirement

Fully paid-up, convertible debt should be convertible to Tier I capital at the option of the regulator. In essence, subordinated debt should be counted against capital and exposed to potential loss while a financial institution is still a going concern.

Investor coalition

A proportion of asset management fees could be directed to an Investor Coalition, an independent body for Corporate Governance work, that is responsible for addressing shareholder interests and meeting with the Board to question strategies. The coalition would be expected to issue recommendations, help with the nomination of non-executives and would then be held accountable for its own Corporate Governance failures.

Shareholder calls

These would work in a similar way to analyst calls and give shareholders the opportunity to interact as a group with the executive on a regular basis and not just at general meetings. Once or twice a year there should be a meeting between the Non-executive Board and shareholders.

New approaches to risk management

Audit and risk committees should be separate. Communication with the Board could be improved by the introduction of tutorials for Board members.

It was thought to be vital that the Chief Risk Officer report to the CEO, as there will be occasions when he or she needs to challenge the Chief Financial Officer. The Chief Risk Officer should also meet with non-executive directors alone. This would allow for transparency and avoid influencing behaviour from the CEO. In turn, the CEO should attend all risk committee meetings. Quarterly meetings between CEO, Chairman and Chief Risk Officer were also advocated. Finally, the risk committee should meet the day before the Board meeting.



Rethinking roles and relationships

There was a belief that Boards do not always fully understand how banks operate or even how they are financed. Some participants were in favour of a much more full-time role for non-executives, particularly in major banks.

If this were not possible, it was suggested that institutions could explore the establishment of a full-time, properly resourced Secretariat, working for the Board, whose role would be to understand the business activity and strategic intent of the company and provide the information that would allow the Board to challenge the executives effectively.

Another suggestion was that Boards should entirely do away with the requirement to be collegiate. Board meetings would become adversarial, operating rather along the lines of a Treasury Select Committee meeting. As one of the directors said, "Boards must hold management to account – pick up pieces when things go wrong."

Concluding Remarks

In retrospect, failures have become apparent throughout the financial system. While there were flaws in Corporate Governance, these were by no means the whole cause of the crisis. Indeed, to lay too much blame at the feet of Corporate Governance now is to shore up problems for the future. Corporate Governance, as one speaker said, “makes a good company better. It does not make a bad company (magically) good.”

In future, there might need to be less emphasis on process. Clearly what is more important is appointing the right people, with high order integrity and with skills that are appropriate to the market at the time. Maybe there will be a need to rethink attitudes towards the independence of bank Boards, and tenure. Continuity and understanding are valuable, but complacency is dangerous.

A major question for the future is, “How can we go about defeating the ‘herd instinct’ of Boards?” As one speaker claimed, “What was missing was a willingness of non-executives to think outside the box”. But in order to think outside the box, they may feel they need a greater understanding of the companies they serve. Can this be gained by better education, asking them to work longer hours, or ensuring that non-executives in banks are drawn only from the banking sector? Conversely, is someone more likely to think outside the box if their experience is in a totally different sector?

More generally, communications have to be improved. It should be made impossible for institutional investors or risk managers to shrug their shoulders and say “we tried but we were ignored”. The sheer complexity of the sector in general, as well as of individual products and instruments, poses a major challenge in this respect. However, a recurring theme throughout the conference was the efficacy of the “back of an envelope” test. If a bank’s strategy, product, risk, or principles cannot be explained simply and succinctly to an intelligent, but non-specialist person, then non-executives must dig deeper.

Perhaps this is the fundamental test that should be applied throughout the sector.

Frank Froud

Executive Vice President, European Client Management
BNY Mellon



About BNY Mellon



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About Cass Business School



Cass Business School is one of Europe's leading providers of business and management education, consultancy and research.

We are located on the doorstep of the City of London, one of the world's foremost business and financial centres, with campuses in Moorgate and Islington. Our top-rated programmes range from undergraduate to masters, MBA, PhD and executive education. Our reputation attracts students and faculty from around the world.

Cass is home to the International Centre for Research in Corporate Governance. The centre carries out multi-disciplinary research into Corporate Governance issues occurring at a National, European and Global level. Additional information is available at www.cass.city.ac.uk/crcg

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