

A new outlook for boards

*How the economic crisis has affected the boards
of European financial institutions*

Throughout 2009, chairmen and CEOs of banks and other financial institutions came under unprecedented pressure from all sides. It was clear that the social, political and economic significance of their roles — and those of the boards they led — would be felt throughout the downturn and well into the recovery. Their boards were going to remain in the spotlight for a long time to come.

In order to establish how the economic crisis has affected the way boards operate, particularly within the banking sector, and to pinpoint the issues that are causing them the greatest concern, members of Spencer Stuart's European Financial Services Practice conducted face-to-face interviews with chairmen and CEOs of 12 of the largest banks and other financial institutions across Europe.

We interviewed chairmen whose banks had received emergency government funding, and others who had managed to avoid that fate. All of the boards represented in this study have had to get used to a far higher level of accountability to shareholders. What's more, freedom from state funding does not mean freedom from government influence as politicians and regulators have sought to impose operational and behavioural changes across the entire financial services sector. Boards are having to deal with pressure on multiple fronts — to maintain credit flows, increase capital ratios, restore balance sheets to health, minimise risk, limit compensation, reduce staff levels, and restore trust in damaged brands.

It is not surprising, therefore, that boards put themselves through some intense self-examination in the year following the credit crisis. Chairmen reported that governance and board responsibilities are being discussed at length in board meetings and that great care is being taken to tighten up accountability and risk management procedures, both of which had been conspicuously absent in the run up to the crisis. They also acknowledged that changing the composition of their boards has been a priority, the most sought-after candidates being experienced chairmen and current CEOs.

“Shareholders shifted their priorities away from investment performance and share price towards ensuring that the bank navigated the crisis successfully and set up the right conditions for future prosperity.”

INCREASING EXPECTATIONS

While the crisis has not altered the role of the board (its tasks and responsibilities remain broadly the same), the organisational framework has certainly changed. Not only has the number of meetings increased (particularly noticeable at the committee level), but so has the frequency of contact between meetings and the flow of information, especially short-term flash reports. There has been a renewed emphasis on topics such as risk management and liquidity management, both of which require focused effort and deeper expertise among non-executives (NEDs) than was previously the case. As one chairman put it: “The discontinuity and volatility of the business demands short-term reaction and rapid decision making.”

“The board is more nervous and opinionated than in the past — less inclined to follow the proposals of the executive committee without a lot more debate.”

The time burden on bank board directors has grown significantly in every European country since the crisis began. Given the complexity and increasingly technical nature of the banking industry, and amidst constant reminders by stakeholders of their fiduciary and moral duties, directors now recognise that in order to fulfill their responsibilities they must increase their involvement and devote significantly more time to the business than was the case prior to the crisis.

In the UK, the final recommendations of the Walker Review of corporate governance in UK banks and other financial industry entities (November 2009) refers to the “unavoidable need to increase the expectation of time commitment from NEDs as a group.” Walker anticipates an average time commitment for NEDs of 30–36 days per year (the previous average was 25 days). This is likely to have a major impact on the ability of bank board directors to remain plural, on director fees, and on the ability to attract active CEOs from other companies to serve as non-executive directors.

We asked chairmen about how the crisis would affect the board’s level of influence in the future. Boards have received stinging criticism for inadequate supervision of executive teams and for their part in poor decision-making in the lead up to the crisis. Boards have undoubtedly suffered serious reputational damage. Yet their authority has also been strengthened by the crisis, since they hold the key to much needed improvements in corporate governance that investors, politicians, regulators, the media and the general public are calling for.

As a result, boards’ influence over management is getting stronger. Chairmen report that boards are demanding a better line of sight into the actions of executives, exercising greater control over strategy and increasing their involvement in the management of risk. As one chairman put it: “Management is feeling guilty and becoming more open to the board’s contribution. The board will not hesitate to affirm its authority and its power to challenge in a positive way.”

CHANGING PRIORITIES AND THE SUPERVISION OF RISK

For most chairmen there has been a noticeable change in priorities since the crisis began. Boards are having to weigh a variety of sometimes conflicting factors, such as the political environment, taking account of other stakeholders including employees, regulators and the media, and serving the wider interests of society by exercising good corporate governance (these factors all merge in the case of banks under government ownership).

Control and risk assessment have risen to the top of the list for most bank boards, with compensation and the public agenda following close behind. As one chairman commented, the board's strategy horizon has shortened: "Short-term issues such as funding, liquidity, capital requirements, credit and risk have absorbed most of our time. 2009 was not a year in which people thought about the long term."

As banks re-balance their business models, chairmen anticipate that boards will take a far more active role in strategy and control; they are fully aware that, in the past, short-term thinking has jeopardised the long-term interests of financial institutions. "The board will no longer be satisfied approving a pre-established strategy presented by the management. It will dig deeper into all the options and consider a broader range of scenarios, to avoid being surprised by the unexpected. Thinking out of the box has become a necessity."

Prior to the crisis, most bank boards were satisfied that they had addressed the interests of the company and its shareholders by allowing their management teams to go

after high-growth markets, often employing complex financial instruments, which yielded huge gains in the short term. With hindsight, these boards appear to have been almost entirely unaware of the risks these actions posed to the liquidity and solvency of their institutions and to the long-term interests of shareholders. Whether due to complacency or incompetence, this chronic failure to manage risk (and, in the case of mortgage lenders, to price risk) finally resulted in a profound change of attitude towards a crucial aspect of governance; bank boards now recognise that they are fully accountable for the quality of risk processes in the organisation.

"Strategic reviews, both quarterly and longer-term, have become more important items on the board agenda. Also, more work is delegated to committees."

Bank boards seem divided over the most effective way to stay on top of risk. Some have a specialist risk committee, while others make risk a responsibility of the audit committee. One bank's risk committee meets twice a week and particularly concentrates on the approval of credit transactions, however this is a management committee. The executives involved in another bank's risk committee attend every main board meeting when the subject of risk is on the agenda. Most bank boards appear to have broadened the remit of their risk committees since the crisis began and are now scrutinising a more comprehensive set of potential scenarios from credit risk to reputational risk.

As boards become more directly involved in the assessment and management of risk, they must tread carefully, making a clear distinction between their supervisory role and the responsibilities of management: “We now have a formal risk committee composed exclusively of independent directors. The committee’s agenda takes an increasingly holistic review of risk and its supervisory responsibilities. However, it does not interfere in risk-related management decisions.”

“Board debates are of a much higher level today, and directors participate more.”

Not everyone viewed the formation of a separate risk committee of the board as a good thing. One chairman preferred to make risk the responsibility of a more powerful audit committee, to avoid the danger of any issues falling between two committees: “The control of management is tougher. The audit committee conducts a regular review of internal control processes for each division of the bank. It is complicated and hard work for the committee to ensure that what it asks for is properly implemented at the middle management level. Thankfully, the internal audit department is working more and more closely with the audit committee and the full board.” The increased risk of personal liability adds to the dilemma faced by board directors.

It became clear during our conversations that boards are faced with a broader set of priorities than ever before, yet they are also required to penetrate more deeply into specific issues. One chairman warned of the dangers of two-speed boards, where the need to devote more

time to complex subjects means that directors without the requisite technical knowledge may find themselves out of their depth.

EXECUTIVE COMPENSATION

Nothing has inflamed politicians, investors and the general public more than the issue of bankers’ pay. The media has played a significant role in exposing disparities in compensation between banking and other industries, and has been merciless in attacking the culture of ‘rewards for failure’. Compensation committees continue to be in the eye of the storm, putting in place new models, acutely aware of the ‘optics’ of their decisions. “There is no way to fight against the general sentiment that bank CEOs and other ExCo members have not deserved the level of compensation they were used to,” said one chairman.

Compensation advisory firms came in for stinging criticism from several chairmen, who saw them as contributing to past excesses. However, they acknowledged that they cannot do without outside advice completely. “If the board in its entirety deals thoroughly with compensation, it should be able to limit the upside. The board should employ independent advisors, but they should be aware that their studies are not always accurate and may serve the purpose of accelerating the upward spiral of compensation.”

When we spoke to chairmen, many of their boards were still in the midst of rethinking compensation models. What caused them most concern was how to keep CEOs and other key executives motivated by compensation deals geared more heavily towards longer-term incentives. Executives used to guaranteed

bonuses are having to adjust to the concept of deferrals and clawbacks, while accepting that as much as 30 per cent of their future bonuses will be based on qualitative measures. These were defined by one chairman as “attitude, anticipation skills, management effectiveness and quality of decision-making”.

There has been a widespread fear that bowing to public pressure and reducing total compensation packages to the levels found in other industries will result in an exodus of qualified executives — either to competitors or to other sectors entirely. This concern is felt particularly strongly within banks under partial government ownership, but it receives little sympathy from taxpayers. The decision by CEOs of several UK banks to waive their bonuses while defending huge payouts to staff (justified by the need to retain talent) neatly sums up the complexities and contradictions inherent in banking compensation in 2010. In the words of one chairman: “The total revamping of compensation systems will remain a major challenge for years to come.”

BOARD COMPOSITION

As the extent of the financial crisis became known, the composition of bank boards became a prime focus of attention for investors, regulators and the media representing the public at large. Good governance starts in the boardroom and, as many banks discovered to their cost, the consequences of having weak links in the chain — board members who are not up to the task — are potentially disastrous. Most bank boards have replaced some directors since the start of the crisis; some boards have been completely overhauled. It is no longer possible for board members to

be ‘hands-off’. Each director must be able to pull his or her weight and know exactly what their purpose is on the board. It seems clear that across Europe, the banks that emerged comparatively unscathed from the crisis were the ones whose boards were already “fit for purpose”.

“Tensions between shareholders and management have increased. Management is much more under control.”

In the UK, the body set up by the government to oversee its investments in financial institutions, UK Financial Investments Ltd, together with the Financial Services Authority, has been closely involved in leadership appointments within banks at both board and senior executive level. There are clear signs that shareholders are flexing their muscles over board appointments, not just in financial services but in other sectors. In Germany, for example, Hermes’ recent intervention in the appointment of Infineon’s chairman, is likely to have a far-reaching impact on the country’s corporate governance culture.

“In the medium- and long-term, this crisis will have an effect on the composition of boards,” said the chairman of one European bank. “We have always tried to have a balanced mix of expertise in our board, but many boards have had to realise that there is simply not enough expertise in the board room to properly manage a company through the crisis or give adequate advice to the executive board. I believe that specific, relevant competencies and a mix of expertise will be increasingly important when selecting board members in the future.”

This view was shared by several chairmen who recognised the need to surround themselves with directors who can bring specific skill sets to bear. “The key requirements on our board are related to risk, finance and banking expertise,” said one chairman. “HR, compensation and succession planning skills are also very important and have been added to our wish list. This is in contrast to the growth phase when the board mainly consisted of CEOs, entrepreneurs and other specialists from outside financial services.”

In general, chairmen were not particularly worried about the difficulties of attracting high quality directors for their boards. However, some expressed concern that the pool of potential directors is shrinking due to several converging factors: conflicts of interest among the target population; low fees in relation to personal risk; the fear of liability; and the fact that so many highly skilled executives have been tainted by the crisis and cannot be considered as directors for the foreseeable future.

“Boards have to realise there are other important stakeholders besides shareholders. Business leaders do have social responsibilities.”

Today, the two most important criteria for membership of a bank board appear to be financial competence and banking experience. An international perspective is also highly valued, along with experience and expertise in governance and regulatory matters. One chairman reported that he was “paying particular attention to the integrity of board members, as well as the strength of their identification with the bank as a whole.”

While no-one questioned that independence of mind was essential, one chairman observed that the best contributions during the crisis had come from financial experts and acting chairmen and CEOs with experience handling tough situations: “The rest of the so-called independent directors have been less effective, whatever their competencies may be.” On the boards of French banks, the role played by the chairmen and CEOs of major corporates in supporting the chairman of the board during the crisis has been particularly critical.

CEO SUCCESSION

The banking crisis has brought the question of CEO succession to the fore. Half of the 18 largest European banks have had a new chairmen or CEO since the start of the crisis, and the concept of splitting the two roles has gained currency; in France, for example, the roles have been split at every bank with the exception of Société Générale.

An uncomfortable topic at the best of times, succession planning has taken on greater importance during the recession. As the quality of executive leadership has been questioned across Europe, boards have been forced to address the issue. They have gained a deeper knowledge of the senior management team as a result of giving them more time at board meetings to present their activities and discuss strategy.

Nomination committees have become more involved in succession planning, often undertaking proper talent benchmarking and seeking, with the help of executive search firms, a pool of “available and untainted bankers and financial services specialists”, or

even senior executives from other regulated industries, to join both the management team and the board.

The competencies and qualities sought in CEOs have shifted. In addition to professional criteria such as deep financial knowledge of markets and sophisticated products, a banking background and international experience, nomination committees are placing more emphasis on personal characteristics such as social responsibility, business ethics, leadership and communications skills. Another quality expected of a potential CEO today is the ability to resist pressure from shareholders and from within to produce short-term profits at the expense of the long-term interests of the business.

For one chairman, values and integrity form the most important consideration in CEO succession: “The interesting question: is what are the reasons for this dramatic financial crisis? Compliance sets the rules, but the attitude and values of the players within financial services are what really matters in this context. Social responsibility was not on the agenda. The question became, ‘how far I can stretch the law without breaking it in order to do business, finding lucrative loopholes?’ The healthy balance between business and values was lost. As a result, chairmen will focus on personality far more than they used to do when planning for CEO succession. It will be important for candidates to have a proven track record in social and political responsibility. Leaders will be selected on the basis of professional and personal qualifications. Being a person of unquestionable integrity will become important again.”

Not surprisingly, the idea of hiring senior executives from outside the financial services

industry was greeted with little enthusiasm: “The time has passed when a bank could afford to recruit executives who do not thoroughly understand banking, finance or risk matters.”

“Expertise and technical skills remain important prerequisites, but they are not sufficient to become a leader.”

CONCLUSION

Our interviews suggest that a major transformation in board activity has been taking place in the financial services industry across Europe since the financial crisis began.

Risk management and regulatory issues have risen to the top of the board agenda, taking priority over strategic considerations, at least in the near term. Succession planning for top executive posts has become a regular and important item on the board agenda due to the scarcity of qualified and untainted leadership contenders. Improving the structure of executive compensation has also become a pressing concern. Greater care is being taken to ensure that boards have an appropriate mix of skills and experience in order to meet the increasingly rigorous demands of corporate governance. Higher demands are being placed on directors, both in terms of time commitment and technical expertise, and deep knowledge of financial issues has become an essential prerequisite for board directors in the financial sector. All these changes indicate that bank boards are putting themselves in a stronger position to steer their organisations towards sustainable, long-term growth, and help restore stability and faith in the financial services sector.

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