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Abstract

After the governance crisis of 2001-2003 and the regulatory response through the Sarbanes-Oxley Act and the European corporate governance codes, the financial crisis has revealed persistent governance problems in financial institutions relating to executives, non-executives and shareholders. For executives these problems lie in the areas of risk and remuneration. Non-executives may have been insufficiently involved in key decisions and underlying direction of the institutions, despite the strong push to increased monitoring by non-executives through Sarbanes-Oxley and European governance codes. Institutional investors have shown a general lack of engagement with investee companies. The paper continues to critically review the governance provisions for financial institutions set forth in the recent proposals for a European Capital Requirements Directive IV and related Regulation. It concludes that regulation often is not the best way to deal with the persistent governance problems, either because it cannot deal with the intricacies of corporate and human reality, as is the case of board and non-executive director performance, or because it will be ineffective as long as underlying generally held beliefs, world views, assumptions and paradigms remain unaffected, for example in the case of risk culture, remuneration and institutional investor lack of engagement. Regulation may actually worsen the situation in some cases, like remuneration and board performance. It takes courage not to regulate and seek alternative avenues to address such problems.

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It should be strange to wonder whether corporate governance had anything to do with the financial crisis of 2007-2008. Did we not have a governance crisis just 6 years before that has led to an enormous regulatory boost in the field of corporate governance, both in the US and in Europe? Were the regulatory measures taken misguided or simply not enough to tackle the governance problems? Whatever the answer to these questions, the EU Commission is now considering to pile more governance regulation upon financial institutions and listed companies with Green Papers on the corporate governance of financial institutions and remuneration policies,[1] and on the EU corporate governance framework.[2] The Green Paper on corporate governance in financial institutions and remuneration policies in the meantime has been followed by proposals from the Commission on a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and a Regulation on prudential requirements for credit institutions and investment firms (jointly referred to as CRD IV).[3] The proposed Directive and Regulation contain a number of elements seeking to improve the governance of credit institutions and investment firms (in short: banks).

The previous and newly contemplated measures raise fundamental questions about how much corporate governance and its regulation really matter. Did the governance of listed companies improve as a result of the measures taken after the governance crisis, what is still missing and will the newly contemplated measures help? Or are there persistent governance problems that will continue to be of concern regardless of what and how we regulate? If further regulation does not help, what then could be done to improve the quality of governance?

One can understand corporate governance to include the internal design of governance relations within a company plus the external regulatory and enforcement environment which impacts the governance of the company. The latter is particularly relevant for financial institutions. Many aspects of the regulation of the business of financial institutions may have contributed to the financial crisis but I will not seek to address all the problems laid bare by the financial crisis. Failing corporate governance probably was not one of the decisive factors explaining the financial crisis, but good corporate governance would have helped to mitigate some of its effects and where it was in place it may actually have insulated some financial institutions against the worst consequences of the crisis. This essay is restricted to internal governance relations, focusing on executives, non-executives and shareholders as the key players. In part I. I will first provide a short overview of measures taken in the wake of the governance crisis. Part. II will address what I believe to be persistent governance concerns for executives, non-executives and shareholders as became apparent during the financial crisis. Part. III will look at the proposals included in the CRD IV Directive and Regulation and review to what extent they will enhance the corporate governance of financial institutions. I will not extend the analysis to governance of listed companies in general but only state here that what may be needed in terms of governance regulation for financial institutions may not at all be warranted for listed companies generally. The specific position of creditors of financial institutions, including depositors, and tax-payers as a result of government bail-outs, and the systemic risk certain financial institutions may generate are very different from the regular listed company. The overall gist of this paper is that regulation will only be of limited help and that we should explore other avenues to improve the quality of corporate governance. That conclusion seems all the more relevant for listed companies in general.

I. The Governance Crisis of 2001-2003

The governance crisis of 2001-2003 was severe. A number of companies in the US had to restate their financial statements and admit substantial and fraudulent misstatements. Some of these companies failed spectacularly, like Enron, Worldcom and Tyco. Executives have been convicted to substantial prison sentences for frauds on the basis of legislation in place before the governance crisis. Apparently the clear prohibitions and tough sanctions were not sufficient to prevent the widespread fraudulent behaviour. These scandals and failures led to fast and mandatory legislation through the Sarbanes-Oxley Act, with world wide implications for listed companies with share listings

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[1] See http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm.

[2] See http://ec.europa.eu/internal_market/company/modern/corporate-governance-framework_en.htm .

[3] See http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm .

in the US. Although some in Europe initially believed this was a typical American problem, Europe followed suit with scandals involving Parmalat, Royal Dutch Ahold and others. The European response however was different, not through mandatory legislation, but primarily through Member State corporate governance codes based on comply or explain after the UK example, with some supporting legislation at Member State level. Politics and perception caused these different responses.

In the US historically a distinction is made between the regulation of corporate law and the regulation of securities law. Corporate law is a matter for the states that each have their own corporations act. Securities law however is primarily a matter for federal regulation. The development of corporate law is partly characterised by the dynamics of a competition for corporate charters between the states. The state of Delaware is the leading state in terms of numbers of company registrations, certainly among the larger companies in the US. A substantial part of the state's budget is actually financed through corporation fees of corporate registrants.[4] As a result, Delaware in matters of corporate law is relatively management friendly, as the place of registration is typically chosen by the management of a public corporation. This theory on the driving force behind the competition for corporate charters has been confirmed by the governance crisis of 2001-2003. States like Delaware did not respond at all to the crisis and did not implement any new corporate law regulation to try to deal with the perceived causes of the crisis. The federal government however is less sensitive to the management agenda and did respond to political pressures that arose as a result of the Enron and other scandals. As the primary area of authority for the federal government is securities regulation, the problem underlying the scandals was first of all seen as a problem of failure of information to the market. The response through the Sarbanes-Oxley Act was therefore focused on solving this problem, by imposing new rules on internal control and risk management relating to financial statements, certification of financial statements by executive directors and external auditors, the role of audit committees consisting of independent non-executives and by strict rules on auditor independence and oversight, all to ensure the reliability of the financial information listed companies provide to the market. Because the tool available to the federal government to impose these new rules was securities regulation, the nature of the regulation was mandatory, with public oversight by the SEC and enforced by public law and criminal law sanctions. One aspect of the new rules could just as well have been regulated through corporate law and that is the enhanced role of independent non-executive directors in the audit process through the mandatory audit committee. Here we see that the federal government, through federal securities regulation, intervenes into the realm of the states' authority on corporate law.[5]

In Europe the perception of the underlying problem and therefore the solution proposed was fundamentally different. The High Level Group of Company Law Experts that I chaired in 2001-2002 believed the underlying problem was a not only or primarily a matter of the quality of information to the market. More fundamental governance issues were underlying the reporting failures, relating to the role non-executive directors, their independence, the remuneration of executive directors and the lack of involvement, or as we would call it now, the engagement of shareholders in the governance of their companies. The scope of the issues being so much broader than information to the market we did not believe that mandatory legislation, particularly at EU level, would be the right way to address the issues. Instead we recommended that member states in the EU each adopt a national code on corporate governance, which should contain governance principles and best practices that would not be mandatory, but should be enforced on the basis of comply or explain, following the UK example. Shareholders would then primarily be responsible for enforcement of the codes, by exercising their shareholder rights in order to persuade the board to change its mind on compliance with the code.[6] This model has become the major European response to the governance crisis. Member states now all have a corporate governance code.[7] Listed companies are required to disclose in their annual report to what extent they comply with the relevant code and explain deviations, see art. 46a of

[4] Bratton and McCahery report that around 20% of revenues of the state of Delaware comes from franchise taxes and corporation fees, see Bratton, McCahery (2006), p. 80.
[5] See Winter (2006), p. 20-26.
[6] See for the report of the High Level Group http://ec.europa.eu/internal_market/company/modern/index_en.htm.
[7] See for an overview of codes http://www.ecgi.org/codes/index.php.

Directive 2006/46/EC, amending the 4th Company Law Directive on Annual Accounts. In addition the EU Commission has issued Recommendations to member states on the role and independence of non-executive directors and on executive remuneration.[8] These recommendations are not binding on member states but lead to a certain pressure to address these issues, either through legislation or through corporate governance codes. The EU did not completely ignore the US approach of seeing the problem as a problem of information to the market. The EU amended the 8th Company Law Directive on the audit of annual accounts. The amendment led to more stringent rules on auditor independence and oversight over auditors and specification of the role of the audit committee or the full board if the board has not set up an audit committee. What was not taken over from the US was the requirement of certification of the annual accounts by external auditors, the element of Sarbanes Oxley Act that caused most of the formalities and costs for companies. In a way the amended 8th Directive is Diet SOX.

II. Persistent Governance Problems

Whatever measures the EU and the US have undertaken following the governance crisis, the financial crisis has shown that governance questions persisted. There were problems and failures for each of the three key players in corporate governance: the executives, non-executives and shareholders.

Executives

Much of the criticism that has been exercised in the wake of the financial crisis was addressed to outsiders and gatekeepers, such as governments for deregulating the financial industry, supervisory authorities for not understanding what was going on and not intervening when they should have and credit rating agencies for issuing phoney credit ratings. The heart of the problem however clearly was in the primary business processes of financial institutions for which the executives carry the day to day responsibility. From a governance perspective two matters stand out: risk and remuneration.

Risk

The crisis has revealed a monumental failure in the understanding and management of risk within financial institutions. Risk management was notionally one of the areas of heightened attention under Sarbanes-Oxley and comparable regulatory initiatives in the EU. It was often mentioned in one breath with internal control. The focus of attention was to ensure that companies would be sufficiently aware of material risks they were facing and would report on them adequately. Nonetheless risk management of financial institutions failed dramatically. The failure is many-fold. The final verdict has not yet been given, but there are strong indications that financial institutions have overrelied on quantitative risk models as the primary tool for understanding and addressing risk. Nassim Taleb in The Black Swan has cursed this use of quantitative models as a misguided way of understanding risk. A well known problem is that these models typically use historical data, ignoring the actual behaviour of market players, including the behaviour based on the predictions of the model, and its impact at the moment that the risk is to be assessed. Also, quantitative models leave areas of which it is clear that the risk cannot be quantified adequately, the tail risk, but then create the perception that it is a negligible risk.[9] The understanding and management of risk may also not have had a predominant position within many financial institutions, swept away by immediate commercial concerns and substantial personal incentives created by performance based pay schemes. Finally, individual institutions have not been sensitive to the systemic risk caused by the multitude of players in highly interwoven markets. Modern technology and securities innovation allowed for ever more diversification of risk throughout the global financial system, creating an illusion of limited risk for each individual player. The resulting overall, systemic risk was intellectually identified by some but this did not lead to precautions and changes in behaviour of individual institutions. For individual institutions it was rational to keep on dancing as long as the music played, as Citigroup's CEO at the time, Charles Prince,

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[8] Recommendation of 15 February 2005, see http://ec.europa.eu/internal_market/company/independence/index_en.htm, and 14 December 2004 and 29 April 2009, see http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm.
[9] RIMS White Paper (2009), p. 5.

infamously said. But collectively the dance whirled into an irrational disaster. All of these factors undermined the effectiveness of risk management systems that were in place in financial institutions.
There is a second area of risk failure, beyond the organisation and techniques available for risk management. Behavioural and cultural obstacles may stop any risk management system from becoming effective. Human decision-taking is subject to a wealth of cognitive biases that may severely impact the quality of our decisions. The confirmation bias makes us look for and take notice of information that confirms our initial beliefs or preferences, while ignoring contradictory information. The overconfidence bias makes us believe that we are better, smarter and more objective than others and can pull things off that others cannot. When objective information tells us otherwise, we solve the cognitive dissonance by creating self-serving justifications. The commitment bias makes us escalate our commitments and persist beyond the level suggested by rationality.[10] These and similar biases may frustrate our awareness of risk and our sense of urgency in dealing with risk.[11] Corporate culture also plays an important role. A corporate culture of aggressive pursuit of profits with a win-at-all-cost mentality is prone to higher risk-taking and to being arrogant about the risks that are being run.[12] The financial industry seems to have been captured by this culture more than any other business sector, fuelled by substantial and in a number of cases excessive personal gains that could be made by the key players in the industry. This also appears to still prevent many in the industry to acknowledge what went wrong and to be willing to make the necessary changes in their behaviour.[13]

Remuneration

This naturally takes us to remuneration as the next area of concern that has received wide attention. Remuneration has a tendency to take centre stage in any public discussion on governance failures, as if it is the only or most important issue. This is probably because remuneration is not just a technical issue but has everything to do with perceived fairness, which leads people to make moral judgements.[14] Even if we filter this factor out, executive remuneration remains troublesome. For executives of companies, performance based remuneration was hailed as a way to mitigate a fundamental corporate governance problem, the so called alignment problem. Executives as agents do not necessarily have sufficient incentives to act in the interests of shareholders as principals. By providing executives with materially the same incentives as shareholders alignment of interests would be achieved, as the theory goes. Earlier criticism by Bebchuk and Fried and by Jensen and Murphy has indicated that the design and governance of executive remuneration systems are often poor.[15] Governance regulation, primarily through corporate governance codes in the EU, has attempted to address these problems. But a more fundamental problem remains: modern behavioural, psychological and neurological research indicates that human beings cannot handle performance based pay, for a number of reasons.[16] Our intrinsic motivation is crowded out by financial incentives, affecting both what we seek to achieve and our ability to make judgements and assessments when we need to. The more substantial the variable pay becomes the more we believe that the only reason we should perform well is the remuneration we receive as a result.[17] The potential of large variable pay also constricts our cognitive awareness and skills that we need in particular when we face complex and uncertain situations.[18] Performance based pay and the system of target setting and measuring inevitably leads to cheating in order to ensure, first, that targets are relatively easy to meet and, second, that targets are indeed met even if the ultimate cost to the company is huge, or are seen to be met while they are not.[19] At the same time we have an extraordinary self-serving ability to rationalise our behaviour as normal and appropriate as a result of which we no longer even recognise that we are

[10] Bazerman, Moore (2009).
[11] Harner (2010), p. 23-27.
[12] Id. At p. 28.
[13] Graafland, Van de Ven (2011)
[14] Sandel (2009), p. 12-18.
[15] Bebchuck, Fried (2004) and Jensen, Murphy (2004).
[16] Winter (2011a)
[17] Fehr, Gächter (2000), Ariely (2008)
[18] Pink (2010), p. 44, 62.
[19] Jensen (2003)

gaming the system.[20] Benchmarking executive pay with the pay peers receive at other companies makes remuneration the predominant factor through which people define their social status, leading to an upward spiralling unrelated to any performance.[21]
To conclude, substantial performance based pay brings out the worst in us. More than anywhere this has happened in the financial industry, with a singular focus on immediate personal financial gain, regardless of the risks to the institution, let alone to customers, other outsiders and society at large. From a governance perspective, executive remuneration through performance based pay is a failure.

Non-Executives
The financial crisis brought down some powerful finance houses with long histories. William Cohan describes the collapse of Bear Stearns in *House of Cards, a Tale of Hubris and Wretched Excess on Wall Street*. Lawrence McDonald and Patrick Robinson tell the story of Lehman Brothers in *A Colossal Failure of Common Sense, The Inside Story of the Collapse of Lehman Brothers*. The stories are extraordinary and stupefying. From a governance perspective one element strikes me in particular: there is practically no involvement of the board of directors in the whole process, at least none of its involvement is recorded. To some extent this may be due to the perspective of the authors but my take is that the books are just revealing what happened in practice: the boards had no significant and meaningful contribution to the core business, strategy and risk appetite and management of these two banks. We see the same in the Netherlands where Jeroen Smit recorded the tale of ABN AMRO in his book *De Prooi*. The once so proud nr 1 Dutch bank after years of underperformance became the target of a takeover battle finally won by a consortium of RBS, Banco Santander and Fortis. The supervisory board in the two-tier structure of ABN AMRO is almost completely absent from the story. Again, this does not only appear to be the author's perspective but shows the limited involvement of the supervisory board in the affairs and strategy of the bank. Apparently, the effects on banks of Sarbanes-Oxley and the code movement in the EU have been minimal. In the US the CEO dominance of boards is one factor explaining the lack of involvement of non-executive directors. For banks in general there seems to have been a common view that non-executive or supervisory directors have little to contribute as banking is so special and requires particular expertise that cannot be expected from your average non-executive director with limited time available. Often non-executive directors seem to have been chosen primarily for their contribution to the bank's network in the business community and not to strengthen the governance of the bank itself.
At the same time, if you would have reviewed the formal governance arrangements of financial institutions prior to the financial crisis, most if not all of those subject to the requirements of Sarbanes-Oxley and the governance codes in the EU would have shown exemplary formal governance arrangements in place. Such formal governance arrangements do not guarantee that the board is truly on task. It is relatively easy to have all arrangements in place in a box-ticking, window-dressing kind of fashion, with non-executives still only superficially involved and without a grasp of the true nature of the company's business, its prospects and challenges. Even where the stated intention of both executives and non-executives is to have the board function properly, applying best practice governance tools and committed to the company's success and future, this still leaves wide scope for ineffective board practices. In the course of a range of board performance reviews that I have conducted in the last few years, I have experienced how difficult it is for boards in practice to reflect on their performance. This is not only the case when there are clear personal or functional conflicts between executives and non-executives that preclude real discussions from taking place. One of the consistent findings in these reviews is that executives and non-executives and the individual members within each group often have different views on what the role of non-executives vis-à-vis the executives actually is and what it entails in practice for the behaviour that is expected of non-executives and executives, and most importantly, that they do not know of these differences because they are never discussed. Good board performance does not solely and not even primarily depend on the presence of formal governance arrangements but depends on an intricate web of perceptions, beliefs, drives and fears, personal skills and group dynamics that go way beyond formal governance

[20] Mazar, Amir, Ariely (2008)
[21] Layard (2005)

arrangements. The impact of regulation of formal arrangements on this intricate web is only limited and indirect at best.

Regulation may actually have contributed to the lack of meaningful involvement of non-executive directors. The independence requirements imposed by Sarbanes-Oxley for audit committees, by the New York Stock Exchange also for other board committees and by European codes for non-executive directors and supervisory boards in general, may have actually contributed to the weakness of bank boards, by excluding as not independent people who had worked for the bank or had banking experience from other related institutions. Paradoxically, the more we insist on the independence of non-executive directors according to a set of formal criteria based on previous and current relationships with the company and its management, the more dependent the independent non-executives become of the executives as their single source of information and perspective on the company, its performance, prospects and challenges.

This also relates to another factor that may have hampered the involvement of non-executive directors: their perceived lack of expertise. Hau and Thum examined the background and experience of directors of German public and private banks and established a pronounced difference in finance and management experience of non-executive directors between public banks and private banks, the first scoring significantly lower than the second. This relates directly to the magnitude of bank losses in the financial crisis, public banks having lost significantly more than private banks.[22] Competence seems to matter, a reassuring thought. But it is not at all clear what conclusions we should draw from these findings. For one, we should expect that also the experience and knowledge of public bank executives and staff is significantly less than those of private bank executives and staff. If executives do not fully understand what their bank is engaged in, non-executives are highly unlikely to be able to correct this. Also, a number of private banks, with in general better qualified non-executives, showed significant losses up to and including complete bank failures. Finance and management background and experience of non-executives clearly is no panacea against financial crises. Finally, if competence matters the obvious response seems to be to teach non-executives more and harder about the details of banking and finance. But suppose we would have understood this already say five years ago, what would we have taught non-executives from 2006 onwards? That a massive financial crisis is building up and will reveal an unprecedented systemic risk to which virtually all financial institutions are exposed? That you should not rely on the quantitative risk models currently in use at your bank? That you should not trust any triple A credit ratings for tranches of sub-prime securities? It is highly unlikely that permanent education programmes for non-executives would have emphasised any of these views that became obvious only in hindsight. It is difficult to find a good class and a good teacher for a herd on the run.

Shareholders

Two complaints are made against shareholders and their role in the financial crisis. The first is that shareholders were insufficiently engaged in the governance of financial institutions in order to contribute to the disciplining of management. The second is that institutional investors have been overly focused on short term proceeds. The two complaints are related.[23] Short term focused investors have always been around and contribute to the functioning of the market by providing indispensible liquidity. Nowadays however, even investors with a very long investment horizon such as pension funds, in fact have become short term investors. A driving force has been the perceived Holy Grail in the current investment industry: modern portfolio theory mandates diversification as a mechanism to reduce volatility without having to accept lower returns.[24] For asset managers, pension funds and insurance companies the diversification paradigm has become part of the regulatory framework through the prudent person rule as laid down in the Uniform Prudent Investor Act 1995 in the US, the European Pension Directive 2003/41/EC and the European Solvency II Directive 2009/138/EC. They invest in thousands of companies, with small stakes in any individual company. It is impossible for any investor to truly understand all these investments. In fact, the knowledge and expertise of institutional

[22] Hau, Thum (2009).
[23] See for a more extensive analysis Winter (2011b)
[24] Swensen (2000), p. 62.

investors is focused on understanding the performance of their portfolio of investments as compared to other investments that could be made, calculated mathematically in alphas and betas. This explains why a fund must sell a particularly profitable investment as it cannot be expected that such investment will continue to outperform other investment opportunities. In order to be able to do so institutional investors at all times need to be able to trade in their portfolio shares. Constant liquidity is a requirement of modern portfolio investment. This explains why institutional investors cannot live with blocking of shares as a requirement for voting in general meetings and have insisted on the introduction of the record date in art. 7 Shareholders Rights Directive 2007/36/EC.

A further development strengthens this trend. Increasingly institutional investors outsource their investments to external asset managers. These managers offer their clients a range of investment funds according to geographical or sector-based spread, investment category and investment strategy, also offering funds of funds investing solely in other investment funds to cover an even wider market. This intermediation of the investment process leads to a concentration of investment decisions in the hands of asset managers who compete with each other for institutional clients. The competition forces asset managers to constantly show good investment results in order not to loose the competition. The fiduciary duty of asset manager in practice means to not underperform competitors. This reinforces the herd behaviour directed at diversification, following the market and constant liquidity. Other factors, such as the remuneration of individual portfolio managers, prudential solvency rules and accounting rules drive institutional investors in the same direction. In such an environment institutional investors and their asset managers generally will not be able nor interested to actively engage in the governance of listed companies. Pushed by regulation and codes that require or expect such engagement they will at best engage at what I call a compliance level: engaging because and to the extent they have to.[25] It is formalistic, to a large extent thoughtless and easy to outsource to proxy advisors who make their judgements based on general policies, unrelated to the specifics of the particular companies whose shares they vote. It is not the sort of shareholder engagement that good corporate governance assumes.

III. CRD IV: better governance of banks?

Undoubtedly, if we would have taken to heart the observations above this would have contributed to avoiding failures of some financial institutions and mitigating the problems for many others. Good governance would have produced better checks and balances, both among the executives, between executives and non-executives in the board and between the board and shareholders. Good governance can help to avoid that a company becomes a blind animal in a herd running to destruction, by ensuring there is enough reflective space when it matters to consider the company's direction, its success and its vulnerability. Reflective space is the space in which world views and general assumptions can be challenged and debated, where information not conforming to the trend is not ignored but analysed, where potential blind spots can be revealed and where outside views are actively sought and taken in. Overreliance on quantitative risk models, high performance based pay, exuberant and arrogant profit-driven cultures, non involvement of qualified non-executive directors and single-minded short term focus of widely diversified investors with no real interest in understanding the companies they invest in, are all factors that reduce the reflective space for companies.

But good governance is not a cure for all ailments. Herds are hard to stop, particularly if they have been running hard for a long time and many in the herd have gained success by doing so and have forgotten how close the cliffs can come. Fundamental flaws in the financial system and its supervision can create incentives that are so powerful that no amount of good governance at the level of individual institutions can control it. Even where good governance clearly would have beneficial effects, it is not always clear that and how governance can be improved through regulation.

Risk governance

For financial institutions an area where immediate improvement seems to be possible through regulation is the governance of risk. Audit and internal control were the focus of regulatory work and efforts in practice following the governance crisis, with risk management nominally included but not

[25] Winter (2011b), p. 12.

truly addressed. For financial institutions addressing risk has always been an explicit part of the regulatory environment, mainly through capital requirements. The revision of the European Capital Requirements Directives through a Directive and a Regulation (CRD IV) now takes it one step further: the internal governance of risk management is being addressed explicitly. The proposed Directive contains a number of measures on the governance of the risk management function:

- credit institutions and investment firms (in short: banks) are required to establish a risk committee composed of members of the management body who do not perform any executive function in the bank, art. 75 par. 3. The competent authority may authorise a bank not to establish a separate risk committee taking into account the nature, scale and complexity of the bank's activities. So no comply or explain, only with permission of the national regulator a board can avoid setting up a risk committee.
- The risk committee shall advise the management body in its supervisory function on the institution's overall current and future risk appetite and strategy and assist the management body in its supervisory function in overseeing the implementation of that strategy, art. 75 (par. 3).
- The competent authority shall ensure that banks have a risk management function independent from the operational and management functions and which shall have sufficient authority, stature, resources and access to the management body. The head of the risk management function shall be an independent senior executive with distinct responsibility for the risk management function. What exactly is meant with 'independent senior executive' remains unclear. I presume this means that the executive has no responsibility for commercial or other managerial functions within the bank. Further, the head of the risk management function shall not be removed without prior approval of the management board in its supervisory function and shall have direct access to the management board in its supervisory function when necessary, art. 75 par. 5.
- The Regulation uses a peculiar definition of management body, different from normal corporate law descriptions of a board as a legal body of the institution. "Management body means the governing body of an institution, comprising the supervisory and the managerial functions, which has the ultimate decision-making authority and is empowered to set the institution's strategy, objectives and overall direction. Management body shall include persons who effectively direct the business of the institution. Management body in its supervisory function means the management body acting in its supervisory function of overseeing and monitoring management decision-making. Senior management means those individuals who exercise executive functions within an institution and who are responsible and accountable to the management body for the day-to-day management of the institution," art. 4 (82-84). These definitions only encompass the one-tier board and are not easily applicable to two-tier board systems. Management body in its supervisory function can be extrapolated to the supervisory board in a two-tier model, but the management board in a two-tier model is not the same as management body in this definition. Sometimes the emphasis is more on the executive role, in other instances apparently the collectiveness of executives and non-executives is meant. It is also unclear whether senior management only includes executive members of the board (or members of the executive board in a two-tier model) and who are part of the management body, or also other managers who are not a formal executive director, but directly report to the management body.
- The management body shall have the overall responsibility for the institution, including approving and overseeing the implementation of the institution's strategic objectives, risk strategy and internal governance, art. 86 (par. 1) (a). Risk appetite is not mentioned here explicitly, but it follows from art. 75 par. 3 that the management body has the responsibility for determining the risk appetite.

The Directive and Regulation further extensively address specific risks in particular with a view to capital requirements. In scattered places throughout the Regulation elements of risk governance pop up. For example, when a bank uses an Internal Ratings Based Approach (IRB Approach) to calculate their risk-weighted exposure amounts, all material aspects of the rating and estimation processes shall

be approved by the management body or a designated committee thereof and senior management, art. 185 (par. 1). Strangely enough it is then provided that senior management shall have a good understanding of the rating systems designs and operations, without mentioning any required understanding of the management board, art. 185 (par. 2). Similarly, the management body and senior management shall be actively involved in, and ensure that adequate resources are allocated to, the management of counterparty credit risk (CCR), but only senior management is required to be aware of the limitations and assumptions of the model used and the impact those limitations and assumptions can have on the reliability of the output and of the uncertainties of the market environment and operational issues and of how these are reflected in the model, art. 280 (par. 4). Should the management body as a whole, including the non-executives, not be aware of any limitations and assumptions of models and rating systems and understand their impact on risk assessments?
An interesting reflection is included in art. 170 (e): "if a bank uses statistical models and other mechanical methods to assign exposures to obligors or facilities grades or pools, it shall complement the statistical model by human judgement and human oversight to review model-based assignments and to ensure that the models are used appropriately. Review procedures shall aim at finding and limiting errors associated with model weaknesses. Human judgements shall take into account all relevant information not considered by the model. The bank shall document how human judgement and model results are to be combined." This attempt to factor in human judgement as a counter-weight against model-based conclusions is admirable, but what human judgement precisely is to do and how the appropriate level and quality of human judgement is to be achieved is beyond regulation. For example, saying that human judgement should take into account all relevant information not included in the model gets us to a difficult predicament of human intelligence. If we would know certain information to be relevant we would have included it in the model.
The overall approach to risk in the Directive and Regulation is extensive, detailed, relying heavily on capital requirements to curtail risk opportunities and with strong involvement from national regulators on a detailed level within institutions. One should expect this to have a strong impact on risk appreciation and risk culture. This will not completely protect the financial industry against risk follies following from new herd behaviours, the systemic problem of individual players' insensitivities to systemic risks and risk forgetfulness that may crop up in the future. A tightening of risk governance, through a more explicit role of non-executives in the management body and its risk committee and a stronger risk management function within institutions may help but offers no guarantees either. One aspect warrants attention. The Directive chooses a mandatory format, for example mandating non-executive risk committees, with exceptions only possible if the national regulator so permits. This removes the debate on the proper governance of banks from a discussion between board and shareholders on the basis of the comply or explain principle to a discussion between board and regulator. In the area of risk governance I appreciate that this regulatory choice is made, in light both of the natural relation between risk governance and prudential supervision of risk-taking by financial institutions, as well as the devastating impact risk failures have had on financial institutions, their creditors and tax-payers. But the Directive extends this format of mandating specific governance arrangements unless the regulator permits otherwise beyond the regulation of risk, as we will see below and this worries me. The governance of banks is pulled into a compliance debate with the regulator outside the scope of the governance relations with shareholders, which I am afraid will not improve the governance of banks. There is not one corporate governance format which constitutes the best arrangement for all companies or financial institutions. The aptness of the reason for deviation is, in general, best judged by the shareholders rather than the regulator. I am not convinced that beyond the area of risk governance there is sufficient reason for deviating from this starting point of sound corporate governance.

Remuneration

On remuneration the Directive contains a number of provisions relating to primarily the design of performance based pay systems. They follow earlier versions in the Commission's Recommendation on remuneration policies in the financial services sector,[26] and amendments to the Capital

[26] See http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf. .

Requirements Directive (III).[27] The proposals seek to mitigate the incentives for risk-taking through variable pay by requiring an appropriate balance between variable and fixed pay, including non-financial performance criteria, a multi-year framework, adjustments for risks and deferred pay-outs, art. 90. They relate not only to senior management but also to so called risk takers, staff engaged in control functions and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profile, art. 88 (par. 2). A remuneration committee consisting of non-executive members to monitor all of this is required for significant banks, art. 91.

All of this may sound nice, but none of it addresses the fundamental problems I have identified above that relate to the psychological and behavioural effects of substantial performance based pay. In fact, regulating the design and governance of remuneration in ever greater detail is likely to have the paradoxical effect of reducing the sense of personal responsibility of those who receive substantial performance based pay. Additional design elements are likely to enhance the control-nature of the incentives, targets and wider conditions of performance based pay. They will have precisely the unintended effect of crowding out executives' intrinsic motivation to perform well and responsibly and will provide ever more incentives to cheat and manipulate and to not feel bad about it.[28] What is needed is a fundamental overhaul of the role of remuneration and incentives in the financial industry. This requires a paradigm shift of deconstructing the myths surrounding the financial incentives and creating new narratives that are built on what really motivates people.[29] Without this, regulation will not help and possibly even do harm.

Non-executives

The Directive contains various elements that seek to address the role of non-executive directors:

- The Chairman of the management body cannot be the CEO, unless justified and authorised by competent authorities, ar. 86 (par. 1) (c). Again, no comply or explain but a clear prohibition of the Chairman-CEO unless the national regulator permits.
- Banks must establish nomination committees consisting solely of non-executive directors which shall identify candidates to fill management body vacancies, evaluating knowledge, skills, diversity and experience of the management body, prepare a description of the roles and capabilities of a particular appointment and assess the time commitment expected, art. 86 (par. 2) (a), and periodically assess the structure, size, composition and performance of the management body and the knowledge, skills and experience of individual members, art. 86 (par. 2) (b and c). It seems this provision is the basis for board evaluations. No reference is made to external facilitation of board evaluations for example every three years, which is an element of some national codes.[30]
- Members of the management body shall not at the same time combine more than one of the following combinations:
    - One executive directorship with two non-executive directorships
    - Four non-executive memberships.

  Competent authorities may authorise a member of the management body to combine more directorships if this does not prevent the member from committing sufficient time to perform its functions, art. 87 (par. 1) (a).
- The management body shall possess adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main risks. Each member of the management body shall act with honesty, integrity and independence of mind to effectively challenge the decisions of the senior management when necessary, art. 87 (par. 1) (b and c).
- Competent authorities shall require banks to devote adequate human and financial resources to the induction and training of members of the management board, art. 87 (par. 2) and to take into account diversity as one of the criteria for selection of members of the management body.

[27] See http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf.
[28] Winter (2011a), p. 17.
[29] More extensively Winter (2011a), p. 19-28.
[30] See for example the Dutch Banking Code, adopted by the Dutch Banking Association NVB in 2009, offers an example, see http://www.nvb.nl/scrivo/asset.php?id=291515.

In particular, banks shall put in place a policy promoting gender, age, geographical, educational and professional diversity on the management body, art. 87 (par. 3).

- EBA shall develop draft technical standards, to be adopted by the Commission, on the notion of adequate collective knowledge, skills and experience, the notions of honesty, integrity and independence of mind, the notion of adequate human and financial resources devoted to the induction and training of members of the management body and the notion of diversity, art. 87 (par. 5).

I am seriously concerned about these proposals. On the one hand they intervene strongly in the governance of banks, for example by mandating separation of the roles of CEO and Chairman, prohibiting more than four non-executive functions for members of the management body of a bank (I presume this includes non-executive functions at non-financial firms) and promising a raft of technical standards. Technical standards on notions as honesty, integrity and independence of mind in particular are a prospect nobody should look forward to. They are likely to contain statements of motherhood and apple pie or take unworkable and irrelevant formalistic approaches to these basic human concepts. They will not strengthen personal responsibility but in fact reduce it. As I noted above, in this sweeping intervention the debate on governance is removed from the shareholder – board relation and replaced by a compliance relation with the regulator, on the basis of detailed and mandated rules. This also has the effect of reducing the responsibility that board members feel for the quality of the governance as they frame governance in the concept of rules that need to be followed, rather than in the concept of responsibility for the company that needs to be ensured

At the same time, all of these measures only seem to just scratch the surface of good board performance. As I noted in part. II, formal governance arrangements are not the key indicators of good board performance. What really matters, executive and non-executive board members' behaviours, perceptions, attitudes, drives, fears and the dynamics in the group, escape direct regulatory intervention. This is for the board itself to address. Effective boards do so, they develop the ability to not only speak about the immediate business realities, but also about their own performance and where and how they can improve. Regular self-evaluation is key for good board performance. However, if behavioural problems hinder the board from being effective, it is likely that the same problems make a self-evaluation ineffective. This particularly is where external facilitators can play a meaningful role, but this is not addressed in the proposed Directive.

I want to stress one other important point in relation to the performance of boards. Regulation promulgated after the governance crisis and the newly proposed regulation strongly emphasise the monitoring duties of non-executive directors, with a focus on controlling executives and ensuring that nothing goes wrong. In practice this is now taking up the largest part of the work of boards. An international board practice results that is focused primarily on detailed performance monitoring, based on regularly updated performance figures and scrutiny of the systems and processes that produce these figures. The key language spoken in board rooms is one of gross margin, operational expenses, EBITDA, underlying growth, leverage ratio, enhanced control environment, KPI's, impairment etc. This focus and language obscure another primary task for boards, and that is to provide strategic direction to the company. If the board as whole, including non-executive directors, is to play a meaningful role in setting, calibrating and changing the strategic direction of the company, including addressing key strategic weaknesses and risks, this requires that non-executive directors are more engaged in the content of the business of the company. The monitoring role typically does not take non-executives to the heart of the business itself and does not allow them to contribute to the core issues that make a business successful or not. The added value of non-executives as a result is limited. It is difficult to see how regulation could lead to a stronger engagement of non-executive directors. The problem does not lie in the board structure, as both in one-tier dominated countries (the UK and the US for example, although their one-tier structures operate rather differently in practice) as in two-tier dominated countries (the Netherlands, Germany), we witness a lack of truly engaged non-executive directors on boards. Nor would detailed regulation on how boards should operate produce the desired result. What is needed is a shift in mind set of executives and non-executives, a next phase to move the contribution of non-executives beyond the monitoring and controlling role to an engaging role, while acknowledging that non-executives are not and should not become simply another layer of executives.

This will create new dilemmas, in particular around the balance between the role of executives and non-executives. How close can non-executives really get to understanding the business at a sufficiently granular level in the limited, part-time they have available? Will too much engagement lead to a reduced ability of non-executives to intervene when necessary? How much can and should executives open up their own dilemmas to non-executives without being perceived to be indecisive and weak? Can non-executives shake off their noncommittal attitude when they really engage with executives on strategy and direction? Boards will have to develop answers to these questions in practice and regulation can not and should not be their primary guidance.

Shareholders

The lack of engagement of institutional investors has been noted in the Green Paper on corporate governance in financial institutions but has not resulted in specific proposals for measures in the CRD IV Directive and Regulation. This issue is not is specific to the financial industry, in fact strong engagement of institutional investors may actually have contributed to banks taking excessive risks in search of ever higher and immediate returns. The issue has been addressed more extensively in the Green Paper on the EU corporate governance framework. Suggested areas where measures could be taken include the asset management contracts between institutional investors and their external asset managers to whom they outsource the management of parts of their portfolios, removing obstacles such as differing definitions of acting in concert across the EU, setting up electronic proxy solicitation and improving cross-border voting, as well as regulating proxy advisors. All of these measures appear only to be mildly useful if there is no change in the underlying modern investment paradigm, based on widely diversified portfolios, mechanical and mathematical investment decisions that require constant liquidity. In such an investment environment shareholder engagement will typically not rise above the level of mindless compliance engagement, with incidental interventionist engagement. Stewardship, a structural engagement not limited in time or to a certain problem, requires something entirely different. Shares are held for longer periods and success of any individual investment is determined on a long-term basis. The increased exposure to each individual investment will require a greater involvement of the shareholder in the company, for example by taking up non-executive board roles, and a different type of knowledge and expertise of the institutional investor, focused on the particular company it invests in. Investing and divesting are not just market transactions but involve contractual arrangements with the investee company. It may resemble aspects of the way private equity firms invest in companies, albeit in a very specific business model.

The proposed corporate governance facilities, including the removal of certain obstacles, will not bring about a broader group of institutional investors with stewardship aspirations. It is not clear what will bring about a paradigm shift in institutional investment, if anything. Warren Buffet promotes a debunking of standard dogma, but will it happen?[31]

If it does not, a further governance question arises and that is how to respond to the consistent lack of engagement of institutional investors. Some would argue that this emphasises the need to facilitate shareholder activism and take-over bids as the only mechanisms suited to discipline management as agent. Others would argue precisely the opposite, if shareholders are not willing to take up a structurally engaged role in the governance of companies, their rights should be restricted. Activism and take-over bids are simply too harsh and overall value destructing and should not be relied upon to discipline management. I predict that this will be the core dilemma for the regulation of corporate governance in the near future, for example when reviewing the EU Takeover Bids Directive.

Conclusion

The analysis indicates that many of the governance problems that financial institutions encountered are difficult if not impossible to remedy through regulation. Sometimes this is the case because regulation is too blunt a remedy to be effective, not able to take into account the intricacies of corporate reality and human reality within it. An example is effective board and non-executive director

[31] Buffet, Cunningham (2009), p. 105.

performance. In other cases regulation is simply not able to address a much more fundamental problem that underlies the governance or design of corporate relations. The herd like effects on risk culture, the self-serving mythology surrounding performance based remuneration are examples of this, as well as, in a different way, the inability of institutional investors to become truly engaged shareholders. The underlying problems in these cases all relate to generally held beliefs, world views, assumptions and paradigms. As long as these remain unaffected regulation will not help. In some instances further regulation will only make it worse and reduce our sense of personal responsibility, as is the case when we create new detailed rules to try to fix the problems caused by performance based pay and to fill in the details of what good board and non-executive performance is supposed to be.
A key challenge of regulation, in general, but certainly in response to a crisis, is to distinguish which problems can be meaningfully addressed by new regulation and which problems cannot. A bigger challenge still is to act on this distinction and to have the courage not to regulate the latter problems but to seek different avenues of addressing them. Such avenues would typically involve challenging and exposing the world views, beliefs, myths and assumptions underlying the current ways of being and acting. This process will take much more time than swift regulation, will produce even more resistance and will at times seem not to yield any results. And yet this may be way more effective than new, ever more detailed regulation. To see this, not only the paradigms on performance based pay, effective board performance and institutional investment need to give way, but also the paradigm of regulation itself as the ultimate and only tool to address problems in society.

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