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NON-EXECUTIVE DIRECTORS OF EUROPEAN UNION FINANCIAL INSTITUTIONS: A PRECIOUS RESOURCE THAT SHOULD BE PUT TO BETTER USE

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Executive Summary

Boards of directors fulfil many functions, but over time two of them have stood out, although neither is set out in the corporate laws that govern them. These are acting as a strategic advisor to management and monitoring management conduct. Historically, advising came first, but lately monitoring seems to have gained the upper hand. Since the Financial Crisis monitoring has been emphasized by regulators and supervisors worldwide as a, if not the, key role for boards of directors of financial institutions. This role is even specified in Community Law in the Fourth Capital Requirements Directive (CRD IV).

In view of the dramatic changes which the financial services sector is undergoing due to technological, environmental and societal factors, including the need to respond to the unprecedented global changes triggered by climate change and the COVID pandemic, as well as sectoral challenges generated by the potential entry into some of their core businesses of Big Tech, I believe this focus, to the extent it precludes adequate attention to strategy, needs to change. Directors, in particular, non-executive directors, already see the need for this. It would be a waste of the perspective and expertise these non-execs can bring to determining the need for and shape of what may be fundamental changes in the way their financial institutions are structured and operate if their limited time were to be monopolized by monitoring management, rather than helping them respond to the forces shaping the future of their institutions.

Introduction

Non-executive directors of financial institutions are very much in demand and the demands on them are becoming ever greater. We are currently experiencing worldwide an increased emphasis on the duties and responsibilities of boards of directors and particularly of their independent members with respect to the conduct and especially the misconduct of the enterprises they serve. Whenever something goes wrong, the question “where was the board?” seems sure to follow. This attention and the attendant pressure on non-executive directors (NEDs) is particularly noticeable in the case of financial

institutions in general and for those in the European Union in particular. The challenges they face have to do with the complexity of modern financial institutions and of their products, coupled with the speed of technological change affecting their core products, traditional services and the very form of their organization. All this is overlaid with the increasingly urgent issues relating to climate change and the central role financial institutions are called upon to play in financing the transition to a lower carbon world. Beyond that, to understand the full extent of these challenges, I think it is useful to put these NEDs and their institutions in their broader legal, institutional and social context. I would liken the tasks facing the non-executive directors of European Union (EU) financial institutions, who serve on a part-time basis, to the complexities of playing three dimensional chess, each dimension following a different set of rules, only one of which is fairly set, the other two evolving more rapidly and in ways not necessarily designed to ease the task of the non-executive director.

The three dimensions

The first dimension is the corporate law of the state under whose laws the financial institution is incorporated, which determines in the first instance how the directors are selected and elected and the roles they can and must play within the corporate entity, the nature of their legal duties to the corporation, its shareholders and other stakeholders, and their eventual liability, civil and criminal, should they fail to live up to those duties. These rules and the related duties are relatively stable and evolve comparatively slowly, based primarily on legislation and litigation.

The second dimension is what I will refer to in shorthand as the banking law and regulation enforced by the authorities which license and supervise the financial institution and which the define institution's license to operate as such. This licensing includes the determination of who is a fit and proper person to act as a director of a financial institution and includes the right to refuse to approve a person or to remove a person as a director for failure to meet the authorities' standards. This power brings with it the ability to define duties and obligations for directors which can diverge from and go beyond those foreseen in corporate law. These rules and the related duties evolve more quickly than the corporate law, based on administrative decisions and can result in

removal of directors and restrictions on or even revocation of licenses to do a banking business. As noted above, I use "banking" as a shorthand for regulated financial institutions. In theory, under the principles of the European Banking Union these rules should be a uniform expression of the Single Rule Book developed by the European Banking Authority (EBA) and enforced by the Single Supervisory Mechanism (SSM) but in fact, to the extent the rules are issued under a European Union Directive, which must be implemented (translated) into national legislation, on a national level, rather than pursuant to a Regulation, which applies directly as written, the SSM has found itself acting under a patchwork of some 600 "national options and discretions". Some of these affect issues as basic as whether the "fit and proper" determination of directors may be made before or after the director is publicly nominated and elected.

The third dimension is that of public and societal expectations concerning the role of directors and of the financial institutions they serve. These expectations can be harder to articulate clearly and can evolve quite rapidly, resulting in the withdrawal of trust from an institution or a whole category of institutions if they are viewed as having violated the social or societal compact under which the public feels the privileges accorded the institutions are justified. And when this trust is withdrawn, the role of the institution's directors is very often held up to scrutiny. This set of considerations has come particularly to the fore with the increasing prominence of environmental, social and governance (ESG) issues.

The banker's dilemma

The first and the third dimension apply more or less equally to all corporate businesses. Directors of Volkswagen can expect to come under just as much scrutiny as those of Wells Fargo when their companies are involved in what appear to be flagrant violations of law and abuse of trust of their customers. However, for financial institutions, whose basic stock in trade is trust and whose products and services tend to seem more interchangeable to the lay person, the consequences may be more severe than for an automobile company whose products are usually more clearly delineated through the branding of their marques in the public mind. The equivalent mechanism for banks may be the so-called "stickiness" of banking relationships which often seem relatively

impervious to changes in public mood, but that stickiness is not without limits. Recent examples of customers switching their accounts in reaction to banks continuing to finance oil pipelines in North America have shown this. The second dimension, however, is unique to financial institutions and complicated by the nature of their business and their relationship with their regulators and supervisors. This relationship was exacerbated by the financial crisis of 2007-2009 (the Financial Crisis) which has been blamed on both "greedy bankers" and on regulatory (and supervisory) failure, as well as excused away as the product of a "perfect storm" for which no one was responsible. Since then financial institutions' boards and their supervisors have been locked into something resembling what Germans call a "Schicksalsgemeinschaft", a community of destiny to see that such events do not recur, with supervisors at times seemingly determined to deputize the boards as quasi auxiliaries of supervision.

Thus while the Financial Crisis resulted in numerous prudential regulations intended to make financial institutions more robust, in particular those packaged under the title of Basel III, regulators and supervisors have also focused on conduct. And there they realized two things. First, that regulating substance, largely ex post, might not be sufficient to control the kind of excessive corporate risk-taking which brought us the systemic externalities which caused the Financial Crisis. Second, that they should have a natural ally within the financial institutions in combatting future excesses, in the person the institutions' boards of directors. The boards have the advantage of inside access to information about the institution, coupled with the traditional duty to control the direction of the institution. An example outside the EU is the UK's Senior Managers Regime. The regime was initially designed to allocate personal responsibility to executive officers of financial institutions who filled designated senior management functions (SMFs), so that not only underlings caught with their hands in the proverbial cookie jar could be held responsible for misconduct, but also those SMFs designated as responsible for the functions involved, if they had failed to ensure proper supervision of the conduct involved. It has since been expanded to NEDs in stages. First to NEDs who perform an enumerated SMF, including chair of the board, risk, audit, remuneration and nomination committees. Finally, the Conduct Rules were extended to all NEDs. Since the UK has

exited the EU, I will stop here, but this is an example of where a certain approach to regulation can take us.

It became increasingly obvious to supervisors and regulators that members of the Board of Directors, including NEDS, could be made into a new line of defense against executive excesses with a few appropriate tweaks to the regulatory structure, by imposing duties on boards of directors to do more than what they had traditionally done, i.e. merely monitor the CEO and management and assess overall strategy, to include an express duty to oversee the risk function in ways which now sometimes seem to go beyond merely evaluating risks to the institution itself to include the risks it poses for financial stability overall, as well as to other, often harder to measure, risks, such as cybersecurity and culture. As relevant financial regulators and supervisors, including the Network for Greening the Financial System (NGFS), whose members include both the European Central Bank (ECB) and the national competent authorities within the Banking Union, expand the definition of financial risk to include the effects of climate change, the scope of risks to be considered has grown exponentially.

The phenomenon of expanded board responsibility applies worldwide, with the regulators and supervisors following the Basel Committee on Banking Supervision's July 2015 Guidelines on corporate governance principles for banks. And so it is within the Banking Union, but here there are two important differences. First, whereas outside the EU, supervisors and regulators are usually acting based on general delegated authority when they increase the pressure on directors, in the European Union, Article 91(8) of the Fourth Capital Requirements Directive (CRD IV) contains a duty for directors "to effectively assess and challenge the decisions of senior management . . . and to effectively oversee and monitor management decision making." While I am not as alarmed about this as the authors of "Quack Corporate Governance, Round III" who see this as opening the door to liability for mere negligence under certain Member State laws, I do think it does make a difference. Second, it is also important to know, as noted above, whether the resulting rules have been formulated pursuant to a directive or a regulation. For example, the so-called "fit and proper" assessments of members of the "management body" of financial institutions, which, somewhat confusingly, include both management and supervisory boards, has been carried out through the use of Article 91

of the Fourth Capital Markets Directive (CRD IV), which as its name indicates, is a directive, not a regulation. It has to be implemented by each member state and they have done so differently (never was the word "translation" to designate this process of implementation more appropriate than here), despite the existence of Joint Guidelines developed by the responsible EU authorities, the EBA and the European Securities and Markets Authority (ESMA) that were meant to provide a uniform interpretation of the Directive. Some Member States quite clearly answered, through their national competent authorities, that they had no intention of implementing certain provisions of Article 91 as interpreted by the EBA/ESMA Joint Guidelines of September 2017, thus leaving the SSM constricted in its ability to impose its own Guide to fit and proper assessments of May 2018 even for the 117 groups (including 1000 companies) it supervised directly in 2020 if the national competent authority views it as in contravention of local law. And of course the competent authorities are not going to impose rules with which they disagree on the institutions they supervise directly. The European Central Bank (ECB) is thus campaigning for a regulation to replace that part of the directive to smooth application and provide the always popular level playing field, but until it succeeds we are living in a world where Banking Union rules can mean different things in Belgium and in Bulgaria, amongst other things with respect to fit and proper.

Actual supervision by the ECB is another matter, to the extent that it takes place under a regulation conferring specific authority on the ECB, including the power to impose requirements on credit institutions to have in place robust governance arrangements, including fit and proper requirements for the persons responsible for the management of credit institutions, "to carry out supervisory reviews" and "to remove at any time members from the management body of credit institutions who do not fulfill the requirements" of EU or national legislation. The same distinction applies to the actions of the EBA. Its Guidelines on internal governance are issued pursuant to a Regulation and competent authorities "must make every effort to comply with them". In contrast, in setting forth guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) the ECB is acting pursuant to a directive and not a regulation, and in any event it is personnel constrained and thus largely dependent on national competent authority staffing in its joint supervisory teams.

Nonetheless, for the significant institutions, what the EBA and the ECB have wrought cannot be ignored and, even if it may not be implemented word for word, it has created the atmosphere in which boards in general and NEDs in particular must go about their business. The expectations of regulators and supervisors are summarized in the ECB's SSM supervisory statement on governance and risk appetite of June 2016 in which the words "challenge" and "risk" recur:

> "The SSM has high and specific expectations regarding banks' boards. Boards should challenge, approve and oversee the management's implementation of the bank's strategic objectives, governance and corporate culture. In this respect, the SSM expects the board to demonstrate its capacity for independent challenging and oversight of senior management. This implies that an institution's board should have an adequate composition and effective organization to ensure that it has the capacity to challenge senior management. The board should include a risk perspective on strategic discussions and demonstrate effective oversight of risk and control functions. In particular, the board should be strongly involved in the validation process and monitoring of the risk appetite framework."

I think we can all agree that the expectations are high, but whether they are specific is another question, and whether it is realistic to expect that a group of part-time NEDs will have the time and expertise to contribute meaningfully in the setting of the institution's risk appetite is yet another. A final question, to which we will return is how exactly a board is meant to challenge senior management who, except in two tier board systems, normally sit on the board.

The corporate law dimension

To return now to the first of our three dimensions of duties and playing fields, corporate law, there are well established theories and related best practices as to the role of boards of directors of corporations, and especially of their non-executive or independent members, within the corporation. Traditionally, there have been two theories of the board's role, to advise management on the strategic direction of the enterprise and/or to monitor the actions of management in the corporate interest. These are theories which have attracted a consensus although they are nowhere to be found in

the relevant laws. Historically, the advisory function came first and brought with it a set of criteria for selecting board members based on expertise, familiarity with the enterprise and ability to get along with management and other directors. In recent decades the monitoring function has come to the fore and brought with it not only new criteria for selection of directors, especially NEDs, but also the question of in whose interests the monitoring was meant to take place. Since the 1970s that question has been answered in the United States with a primary, if not exclusive, duty towards the shareholders. In Europe the answer has been, variously, a duty to the enterprise as a whole or a duty to a broader group of "stakeholders", including not only shareholders, but also employees and, conceivably, the communities in which the corporation operates. This broader view has been taken up recently by an influential group of chief executives in the United States in the August 19, 2019 Statement on the Purpose of a Corporation of the Business Roundtable, signed by 181 CEOs. But none of these corporate law theories has been stretched to cover a duty to preserve financial stability by not taking risks which could cause systemic externalities to spread to other financial institutions. The closest analogy might be to avoid the sorts of risks which could cause serious environmental damage, but this duty differs from the duties supervisors are now asking NEDs to take on in a number of important ways to which I will return below.

On the question of the selection of NEDs three criteria stand out, independence, diversity and expertise. Independence is measured in reference to a number of criteria, material, intellectual and social. An independent director should not be a current employee of the corporation, nor derive a significant portion of their income from the corporation. Whether the NED may be a former employee and how far back that employment must lie is a more difficult issue. Intellectual independence, in contrast, is an attitude of mind, including a willingness to question a consensus and to go behind the facts or theories presented as a basis for action. Diversity on a board is a more recent concern and the nature of diversity is often rather narrowly defined to cover primarily gender and race, omitting background, which can be a key component. More recent work has focused on "cognitive diversity" as a key component of board effectiveness. The theory is that persons of a similar background will tend to have similar blind spots, so that the "collective intelligence" a board brings when looking at a problem is limited and

thus, collectively they will not see the "full picture". By contrast, if a board is cognitively diverse these blind spots will be "cancelled out." Nasdaq Governance Solutions (2021). This approach is not unlike recent studies of successful entrepreneurs in Silicon Valley, which underscore the immigrant backgrounds of many of them, which is seen to have given them a different view of how things could be done better.

Expertise, especially in the financial services area, has often been presented as a major problem for NEDs, based on the theory that the area is so complex that even if you knew what the right questions to ask were or had the luck to stumble upon them, an outsider would simply not be in a position to understand the answers, while on the other hand current industry expertise was held only by competitors who would be unsuited to the role of NED or by retirees whose expertise, especially in the current era of rapid technological, legal and social change, would most likely soon prove to be too out of date to be useful. There is something to this line of argument, but it overlooks two important things. The first is that not all important issues to come before a board of directors are technical in nature. There was nothing technical about the fraud allegedly being perpetrated on the customers of US bank Wells Fargo & Company (Wells Fargo) by opening accounts in their names without their knowledge. If you are continually beating your competition by a wide margin on such simple metrics as new accounts and products per customer, it does not require a lot of expertise to look into management style and employee compensation to realize that something might have been wrong, especially if you had a reporting system that captured and escalated employee whistleblowing reports. This view is reinforced by the decreasing importance directors themselves seem to be putting in subject matter expertise as a criterion for board selection, as noted in PWC's 2020 Annual Corporate Directors Survey discussed more fully below.

The second is that boards hire and rely on experts in a number of areas, ranging from auditing to employee (and especially top management) compensation, to aid in their decision making. This model can surely be expanded to other areas where technical expertise is needed. The report of independent counsel on the responsibility of UK bank TSB's board for the catastrophic problems TSB experienced in 2018 in transitioning from one computer platform to another, which resulted in nearly 1.9 million customers being locked out of their accounts, some for three weeks, specifically faulted the board for

relying exclusively on internal reports and evaluations to judge whether the proposed plan of action was realistic or not, rather than seeking out the advice of an outside expert. So long as the experts are selected by the board which sets the scope of their mandate and they report directly to the board, that should be a reasonable way to augment board expertise. Of course, corporate law tells us that the board may not delegate its duties to outside experts and must question and probe the answers it receives, but if it does so in a careful and thorough way, then that should work as a practical matter and satisfy their duty of care under applicable corporate law.

A further question goes to where the board should devote the bulk of its time. Anecdotal evidence shows that a significant percentage of board meetings and of the materials produced for the board are devoted to numbers and compliance issues. This in turn raises two questions. The first is whether a kind of dedicated secretariat hired by and reporting to the board would not be useful to help analyze and organize the flood of documents which board members often get very close to the meeting dates. This is a variation on the idea of expert help but may be more problematic to implement since the work would presumably be done by company employees whose future advancement would likely depend on management rather than the board, so they might not have the same degree of independence and devotion to the interests of the board as outside experts with the appropriate mandate would have. Still, in view of the amount of documentation involved, it would very likely represent an improvement in board efficiency.

The second question is whether the board, especially the NEDs, should be devoting more time to issues which require fewer numbers to be crunched and more judgment, those which relate to overall strategic direction and those which relate to employee conduct and misconduct and to the culture of the enterprise which largely conditions that conduct. As noted above, questions of strategic direction have in recent years taken a back seat to assessing and policing compliance, the latter being frequently carried out on a micro level rather than focusing on what is often the root cause of compliance problems, which is culture. This strikes me as not the best use of NEDs' time. Other than being clear on cultural and conduct priorities and ensuring that there is an adequate reporting system to transmit those priorities down the line and a secure whistleblowing channel back up, I would argue that much of what the boards are asked to

do in the compliance area could be left to management to free up scarce board time for other matters such as strategy, where the input of NEDs, bringing their outsider/insider point of view can be the most precious.

This is of particular importance as innovations introduced by Fintech firms, whose focus is customer centric, are exposing how product centric and self-referential many financial services organizations are. It is often thought that Fintech innovations are technology or product-driven, but in fact many of them focus on reimagining a product or service from the customer's point of view and are process driven. In the words of one prominent EU bank chair, the key is realizing the customer does not want a mortgage, they want a home and the mortgage is only a step in the process of getting one. Seeing things that way can require a fundamental reordering of the institutional structure, a strategic decision of profound importance, and that is precisely the sort of question NEDs should be asked to bring a fresh outsider's view to. In an era of disruption, where the traditional knowledge of banking markets and products, which bank management clearly has, no longer suffices, NEDs can help bring an understanding of network effects, helping to evaluate customer needs, preferences and new kinds of relationships. Innovation coming from non-traditional market players from outside the industry and at an unprecedented pace may well require the kind of "out of the box" thinking concerning the future of an institution's business model that the tendency towards group think which often arises from a long history of success can generate. An NED coming from an industry which has already experienced profound disruption may well bring a much needed new perspective, if asked to provide it. It is the one function no one else, either inside or outside the corporation, can provide as well as the board can, and its importance is paramount. The role to be played by NEDs in ESG matters may be even greater, as discussed more fully below.

This is not to say that monitoring management is not an important function of a board of directors. The challenges currently facing financial institutions are nicely pulled together in "Banking Disrupted? Financial Intermediation in an Era of Transformational Technology", a report of the International Center for Monetary and Banking Studies in 2019. The authors see the provision of financial services as profoundly changing worldwide, so much so that many commentators are predicting "the death of banking as

we know it". They view "some of the dynamics at stake as unprecedented, not least in terms of their 'hyperscalability'" and ask whether "the threat to the traditional banking model is fundamentally different than in the past" with a need for the incumbents to transform themselves profoundly in order to meet the challenges from outside the industry, in particular from Big Tech, to retain customer relationships and trust in an environment in which the ubiquity and exponential growth of data are having implications as yet poorly understood. "More is different" where data is concerned. And the challenges are coming to banks' core business functions of maturity transformation, payments and information processing. On payments, the example of China is particularly enlightening as to what can happen if the regulatory regime is favorable. Big Tech mobile payments represent 45% of domestic retail payments, an amount equal to 16% of national GDP. The vast majority (92%) comes from just two companies, Alipay and WeChat Pay. Payments represent 17% of annual revenue for the global financial intermediation system according to the study.

The Big Tech firms dwarf the banks in terms of market capitalization and the banks clearly lag them in technology, customer experience and network effects. The banks lead in lobbying and data privacy and protection, but the strategy to meet the challenge is anything but clear: compete head to head, cooperate, provide specific unique banking products and services, become platforms offering rival products or retreat behind your regulatory moat, gambling that Big Tech won't want to submit to regulatory constraints because too small a proposition of their revenues are at stake for them to want to submit themselves to regulation? And this is all taking place at a time when the speed of adoption of innovations is accelerating. The study notes that the time to reach 50 million users has declined from 50 years for telephones to 28 for credit cards, 18 for ATMs, 12 for mobile phones, 4 for Facebook and 1 for WeChat. So I would suggest that financial institutions should do all they can to profit from their NEDs' input on strategy to meet this challenge.

The same must apply to ESG matters as well. In particular, where climate is concerned, with regulators and supervisors pushing out the time lines along which financial institutions are expected to think about their risks and introducing scenario analyses new to the industry, the proprietary knowledge concerning internal processes

and the institution's history which management bring to the table are likely to be less relevant than a broad view of risks and opportunities and the mental agility to react appropriately to them. The approach to climate risk advanced by the NGFS introduces a new way of looking at these risks. It distinguishes between direct risks from climate events, which has been the traditional approach to climate risk, from the even greater transition risks which arise from our political and societal reaction to climate change. Will we continue along our current greenhouse gas (GHG) emissions path, disregarding the Paris Agreement goals for 2030 and 2050, or will we reduce our emissions in an orderly and gradual manner to meet those goals, or start off ignoring the risk and them, shortly before the deadlines adopt in panic a set of more drastic reduction measures to try and make up for lost time? The path(s) taken will determine the size and location of "stranded assets" (assets which are no longer worth their initial value because they can no longer be used for their initial purposes) these measures will create both for the financial institutions and their debtors. These effects are expected to dwarf the direct effects. An example can be found in the 20% write down in the value of its hydrocarbon assets recently taken by BP.

Under the NGFS guidelines, financial institutions are required to develop scenarios corresponding to these three possible paths, over a time line six to ten times longer than their usual three to five year planning horizon. Direct risks are something management clearly has historic data on, but this may not be predictive in view of the nonlinear development of climate risks, with significant tipping points as we use up our existing climate budget. With respect to the likelihood and shape of societal and political decisions, management may not be in a better position to judge the shape of things to come than their NEDs who may well have contact to relevant policy making constituencies outside the firm, such as the public sector and non-governmental organizations (NGOs). Thus I see a significant role for the board here in helping define the institution's strategy and also in conveying the strategy and its implementation to other stakeholders.

But there seems to be quite a way to go before boards fully recognize the importance of the area. PWC's 2020 Annual Corporate Directors Survey indicates that directors are "start[ing] to come around on ESG" under the influence of institutional

investors' concerns, but notes that only 38% of directors say ESG risks have a financial impact on their company's performance — down from 49% in 2019. Female directors are more perceptive here than their male colleagues, with 60% seeing the link between ESG and strategy. A 2020 study conducted by CDP of where financial institutions and their boards are focusing their attention concerning environmental matters indicates that many of them are taking far too narrow a view of their impact on the environment. They are looking at the impact of their own operations, not the impact of their portfolios on the environment. In fact, according to CDP, 49% of financial institutions surveyed indicate they do not conduct any analysis of how their portfolio affects the climate at all. From the answers of the 25% of financial institutions which did report financed emissions, these emissions were, on average, over 700 times larger than their own operational emissions despite not covering their entire portfolios. In climate speak, they are ignoring Scope 3 GHC emissions which CDC view as "always appropriate" for financial institutions to report.

I think it is worth reflecting on what this may tell us about the relationship between the board and management and the wider consequences this can have for the institution involved. To me it hints that the board may be allowing its attention to be directed towards an area where management's expertise exceeds that of the directors. As other studies show, this means that the issues involved are often lodged at the level of facilities managers rather than the C-suite level. I imagine the questions examined may include things like how well insulated buildings are, how energy efficient its data centers are and the like. These narrow factual questions are of course important but at best miss the larger point. If CDP's numbers are right, the boards of these institutions are missing a staggering part of their contribution to climate change. In so doing the board is not focusing on the most difficult decisions the institution has to take in respect to climate: what activities will it finance or stop financing. This can include cutting off credit to long standing customers or taking criticism for sticking with them. These decisions are fundamental to the institution's strategy and future. The wrong call can result in significant damages to the institution's reputation as an increasing number of investors and NGOs are focusing on what they see as the discrepancy between financial

institutions' public statements in favor of combating climate change and what activities they continue to finance.

Let us look at this through the lens of the two alternative roles for the board, monitoring and strategic advice. If the board's role is monitoring management, then focusing on operational risks may be fine. But if its role is strategic advice, it is allowing itself to be distracted from the main event. This raises the question of how consistent such an attitude would be with their fiduciary duty of care under applicable corporate law.

This is not to say that monitoring management is not an important function of the board of directors. On the contrary, monitoring is the one function no one else, either inside or outside the corporation, can provide as well as the board can, and its importance is paramount. The experience of Wells Fargo with its aggressive sales practices is ample proof of that. The Investigation Report of its independent directors dated April 10, 2017, makes clear that aggressive sales practices leading to the opening of unneeded savings and checking accounts were promoted by management and the extent of the problem was hidden from the board of directors. The board in fact only learned of the full extent of the problem (5300 employee terminations for sales practice violations versus the 230 terminations reported to the board) from the contents of the settlement agreement with the Los Angeles City Attorney, the Office of the Controller of the Currency and the Consumer Financial Protection Board (Wells Fargo Report, at 109).

The fact that the report was of the independent directors underlines several things. First, that the monitoring function attributed to the board can really only be exercised by the NEDs. In normal times this can be done by committees set up to be independent and on which only NEDs sit, such as the audit, nomination and compensation committees. Second, that if we want them to monitor risk, the risk committee and any separate compliance committee should also be made up exclusively of NEDS. Third, in an exceptionally serious situation like the sales practices at Wells Fargo, a special independent committee of the board may be needed.

Nonetheless, too exclusive a focus on monitoring management conduct comes at a cost in terms of time and focus. NEDs have limited amounts of time and band width and it is incumbent on companies to ask themselves whether less time should be spent on

monitoring and more on advising. A great advantage a NED brings is a diverse point of view and a different perspective. While those qualities are useful in monitoring the organization, they are arguably even more precious in helping management make sense of a fast changing economic, social and technological landscape where being inside a large organization may inevitably narrow management perspective. While I think there is growing recognition in corporate governance circles that the pendulum needs to swing back somewhat towards the advisory function, in the financial services area there seems to be a perception of considerable pressure from regulators and supervisors to hold back the pendulum and focus boards on their monitoring function. See e.g. Salzburg Global Seminar, Session Report 567, The Corporate Balancing Act: How Can Directors Manage Conflicting Pressures? (Salzburg, 2016) at p.49. I am not sure this is the product of a conscious effort or a lack of appreciation for the limited time and attention NEDs can bring to their job, which require hard choices to be made on where to invest that time.

I will return to this point in the next section, but I would first like to note the progress financial institution boards have made since the Financial Crisis in improving their performance from a corporate governance point of view. An outstanding study posted on the Harvard Law School Forum on Corporate Governance and Financial Regulations on June 11, 2018 surveys the governance of the 25 largest European banks a decade after the crisis (Nestor, 2018) and I find its report very heartening from a corporate governance viewpoint. Board size has been reduced (to an average of 14 down from over 20 pre-crisis) while the number of committees is increasing. New committees include not only the separation of the audit and risk committees required by CRD IV, but also specialized committees, such as nomination, compensation, strategy and conduct, and values committees. While more committees can increase the overall work load on NEDs, they serve a crucial function in sharing the burden among NEDs. Boards have been refreshed: 80 have received new chairs and an increasing number of these chairs are independent, the number of international directors and of women directors has increased (to 25% and 34% respectively, the latter representing a doubling since 2007).

NED levels of expertise have also risen, with at least one NED per board with recent financial experience and 49% with senior risk management experience. The profile of NEDs has also been raised: they are also now almost always the chairs of the

risk committees. Their average workload is now as high as it was at the height of the crisis: on average the boards meet 14 times a year (up from 11.4 times in 2007) and the attendance rate at meetings is a minimum of 91%, with an average of 96%, reflecting a concomitant drop in outside time commitments, in line with CRD IV requirements. Board compensation has risen 60% since 2007, but “pay per day” has remained constant. In fact is has declined in the case of NED board chairs.

These metrics are particularly significant when one returns to the arguments which were originally make to justify focusing the duties of boards on the monitoring to the practical exclusion of other functions. In Legal Models of Management Structure in the Modern Corporation, one of Melvin Eisenberg’s seminal papers on corporate governance, he cites a number of constraints on boards which he believes preclude them from taking a more active role than monitoring. He cites time constraints, based on statistics that 45% of boards surveyed met no more than six times a year and 96% met no more than twelve times a year, with meetings usually lasting only a few hours, he comes up with a total of either 18 or 36 hours a year for meetings and no more than an hour to prepare for each hour of meeting. He concludes that this precludes an active role in making business policy. He further cites constraints of information, with only 17.2% of companies sharing manufacturing data, 21.3% marketing data, 5.7% an agenda and 11% nothing at all. He further asks whether the board providing strategic advice is an important function and whether the board is uniquely qualified to perform it. He concludes that advice is “hardly essential to the corporation’s operation” and that the CEO has many other places to turn for advice.

A comparison between his factual premises and the Nestor Associates data discussed above shows how much has changed in the amount of time devoted to board duties since 1975, reflecting the increased professionalization of boards, especially of their non executive directors. As to the importance of advice, at a time when European banks continue to struggle to improve their operating results, I am tempted to ask how consist it would be with the duty of care which directors have under corporate law for them not to concern themselves more directly with how their institution responds to the challenges they are facing and simply content themselves with monitoring management conduct.

As to whether a NED is uniquely qualified to advise, maybe we can leave it that they are surely no less qualified to opine on how to preserve customer trust, what consumers want, what to do with the branch network or what the right strategy on digitalization is than the bank's executives or its supervisors. I would also say the same applies to investors' and civil society's expectations for the institution, especially concerning ESG matters. With the market and society changing as fast as they are, and with supervisors' expectations concerning environmental issues expanding and deepening as much as they are, the traditional information advantage insiders held concerning the market in which they have historically operated is dwindling fast. The perspective from the outside the NED can bring is surely of considerable value. PwC's 2020 Annual Corporate Directors Survey shows that boards themselves are recognizing that subject matter expertise, in particular industry specific expertise, is far less important to carrying out their duties. PwC notes a 27% decline over five years in the number of directors who see value in industry specific expertise, from 70% in 2015 to 43% in 2020.

An interesting study by McKinsey, entitled "Tapping the strategic potential of boards" from February 2013, notes that most directors realize they should spend more time on strategy, not merely reviewing management plans, but actually debating it. Their input can help de-bias management's approach and help broaden their thinking.

Thus, from a corporate law point of view, the boards of large EU financial institutions are well on the way to implementing what is widely considered as best corporate governance practice, in the process overcoming many of the arguments initially raised against their active engagement in strategic matters. However, their priorities still risk being tipped away from strategy back towards monitoring compliance by the perceived preferences of their supervisors.

The regulatory/supervisory dimension

While I sympathize greatly with the task supervisors and regulators have with respect to complex financial institutions, and see the logic of recruiting NEDs to help, I think that a crisper distinction between what can most profitably be put on to their plates and what supervisors should do themselves could benefit both sides. It could be useful in this respect to contrast between, for example, risk management and culture, and between

risk models and business models. All four are matters of extreme concern to supervisors and boards, but there is a complementarity as to what each group can bring to the table which I believe speaks in favor of a different emphasis to responsibility in each case.

With respect to risk management, it seems to me that the supervisor brings a much broader range of knowledge stemming from seeing how other similarly situated institutions are dealing with similar instruments and risks, than what directors of a single institution have. Looking in from the outside, supervisors are in a better position than insiders or NEDs to spot anomalies in risk or valuation metrics, given the fundamental similarities of the financial instruments and financial institutions involved. Based on this knowledge, are they not in a superior position to question management and challenge their assumptions as to the riskiness of an asset or a concentration of risks, and to suggest or prescribe alternative approaches? The activities of JP Morgan's "London whale" strike me as an interesting example. Who, of NEDs or bank supervisors, is better equipped to evaluate the riskiness of a complex set of derivative trades?

Contrast that with culture, where supervisors can measure what comes out at the end of the process in terms of misconduct, and yet feel ill-equipped to prescribe a particular culture to a particular institution and design the procedures to be followed to implement it. This was brought home to me in the course of a panel I moderated in November 2015 on the topic of "Getting the Culture and the Ethics Right, Towards a New Age of Responsibility in Banking" at the Institute for Law and Finance at Goethe University in Frankfurt where I teach. With me on the panel were a member of the Executive Board of the Deutsche Bundesbank and a Vice President of the Federal Reserve Bank of New York, both of whom championed the importance of culture, an issue the New York Fed had been focusing on for several years already. But both were clearly uncomfortable with being prescriptive with financial institutions on how to create and sustain a particular culture. They clearly felt that culture must come from the inside and not be imposed from the outside.

I thus think that an obvious division of labor suggests itself here. Each area is important, but one party is better equipped than the other to handle it. This does not imply that boards can or should rely on supervisors to filter out risky strategies or that

supervisors can rely solely on boards to deal with culture, but that each should focus more of their limited store of bandwidth in the areas in which they can be most effective. With respect to risk, the board's role should be primarily to ensure that proper procedures are in place to measure and set risk parameters, but not to examine each risk and I have always been somewhat uncomfortable with the idea of their setting the "risk appetite" of the institution, especially when the world is changing so fast that it is hard to know what the risks out there now are. Think unknown unknowns or even known unknowns. While I do see the logic of their input on risk appetite, I think the latter should be set by management and policed by supervisors. Boards cannot and should not dodge their responsibilities with respect to ensuring that there is an appropriate risk management system, but they should resist pressure to "get into the weeds," which would expand their monitoring duties beyond what they traditionally are under corporate law.

We should also recognize the limitations on the results increased involvement by NEDs could bring. There is little empirical evidence evaluating the effectiveness of the degree of board independence on large bank risks. The one study of which I am aware, by Francesco Vallascas, Sabur Mollah and Kevin Keasey of the University of Leeds, entitled "Does the impact of board independence on large bank risks change after the global financial crisis?" appeared in June 2017 in the Journal of Corporate Finance and concluded that the only correlation they could find held only for banks which had been bailed out during the crisis and that in most large international banks the degree of board independence did not influence risk. The lead author is quoted by the Financial Times and other publications as stating that the key impact of their findings "is that we need to rely primarily on the role of regulation rather than the role of governance" to control risk taking. While I think this may be going too far, putting it all in the NED's laps is not the answer either.

With respect to culture, in recent years operational risk, a broad field which covers both systems and individuals which do not perform as expected, has passed credit risk, as measured by non-performing loans (NPLs), as a source of reserves taken and losses booked for many banks. Behind operational risk often stand cultural issues. In fact, a participant in the Salzburg Session 582, a former president of BP America, stated "I have never worked on a crisis where the fundamental problem wasn't culture." An

item in the ECB's November 2019 Financial Stability Review estimates that past misconduct by banks has weighed on global profitability and equity positions of banks over the preceding decade, with the related costs amounting to over USD 350 billion or 15% of total bank equity and that while US banks were particularly hard hit in the immediate aftermath of the crisis, since 2015 European banks have been more exposed.

On culture itself, much has been written about what conduct should be promoted or censured, and of course each institution will have its own particular culture, but it seems to me that three simple goals are a good starting point. First: we do not break either the letter or the spirit of the law; second: we do not take advantage of our information asymmetry vis-à-vis our customers; and third: we recognize our social contract with society. This last point brings us back to the third dimension mentioned at the beginning of this article, but before turning to that theme, a few words concerning a recurring pattern which leads to employee misconduct, which is common to the TSB, Wells Fargo and VW cases. In all three, pressure was put on employees to produce results which were either technically or humanly beyond the norm and little attention was paid to how those results were achieved or even if they were possible to achieve. VW's CEO allegedly said "geht nicht, gibt's nicht", roughly translated as "impossible doesn't exist". Employees were made to understand that goals in each case were there to be met, not missed, regardless of whether they were realistic (and in the case of Wells Fargo, management knew that in many cases they were not), and regardless of the collateral damage incurred. In all three cases that damage was considerable. The IT failure at TSB resulted in what the independent counsel's report characterized as "a complete demolition of trust" and in TSB paying out GBP 370 million in compensation. In the case of VW, "Dieselgate" undercut a key competitive advantage for the company, that of the "made in Germany" brand, as well as resulting in total costs of $30 billion, and counting. In Wells Fargo's case, it is clear that the problem was a cultural one, of how the "Community Bank" in which the misconduct occurred, saw itself, which was as a sales organization and not a service oriented financial institution devoted to furthering its customers' interests. This justified the high pressure tactics on employees to open new accounts (Wells Fargo Report, p.7). Wells Fargo had a metric which recorded when and to what level the new accounts were funded, the Rolling Funding Rate, which declined regularly

as sales efforts increased, so that anyone who cared to look could have understood the game. PwC's 2020 Annual Corporate Directors Survey notes an increase in board involvement in company culture.

Another area which presents challenges to supervisors similar to culture is the business model, which I would distinguish from risk models. With business models, supervisors can judge what comes out in the way of losses, but are reluctant for a variety of reasons to be prescriptive with respect to imposing a business model on a given institution. For one, a single business model would lead to a monoculture among banks, both reducing the variety of services and products available to customers and tending to increase correlation of risks among banks which can be expected to make them more vulnerable to the same shocks. For another, especially in the current atmosphere of rapid change, no one can be sure what the right business model really is, beyond a certain number of platitudes concerning customer centricity, the need to digitalize and better use of available client data without betraying their trust, and the centrality of ESG to their strategy and values. Changes in prudential regulation designed to make banks more resilient have already been accused of causing banks to adopt worryingly similar funding strategies and balance sheet structures, so that supervisors wisely refrain from going further than evaluating the strengths and weaknesses of different business models without pushing banks in one direction or another. See, e.g. Strategic Review of Retail Banking Business Models, Financial Conduct Authority Final Report, December 2018, which evaluated, but did not choose among, various available business models. Here too the board and especially its non-execs, can contribute an important perspective as the banks are left to work out their own business models, in comparison to the more modest role I would see them playing in evaluating their banks' risk models. There is some encouraging evidence that some supervisors are placing increasing emphasis on the importance of board involvement in defining and evaluating the business model. The difference between the traditional term strategy and the more modern term business model may be more a matter of semantics than of substance. To the extent this is so, the shift of emphasis I am advocating and the emerging supervisory trend may be converging.

The social dimension

Evolving even more quickly than the demands of the regulatory/supervisory dimension are those of the social dimension in which I include the increasing emphasis on ESG from both investors and civil society. As Mark Carney, Governor of the Bank of England put in Remarks to the Banking Standards Board Panel "Worthy Trust? Law, ethics and culture in banking" (March 21, 2018), "[a]n industry the scale and importance of finance needs social capital as well as economics capital. It requires the consent of society in order to operate, innovate and grow". All corporations benefit from privileges granted to them by society, whether it is limited liability, unlimited life, special tax regimes and, in some cases, a limited legal monopoly on certain activities. But financial institutions benefit from additional privileges, including, in normal times, deposit insurance to encourage the public to deposit funds with them and access to a lender of last resort to provide liquidity to help them stave off runs. In exceptional times, "bail outs" have been added to that menu. In exchange for these privileges, society feels entitled to require a certain level of conduct. The exact nature of the conduct expected has varied over time. At one point, simply making money was viewed as sufficient. Since the Financial Crisis the requirements have changed, to include ESG concerns, factors important in measuring the sustainability and societal impact of corporations, and the basis for public trust in corporations has also changed.

Prior to the COVID-19 pandemic, trust in financial services was low, reflecting the continued effects of the Financial Crisis. The 2019 edition of the Edelman Trust Barometer confirmed that financial services remained the least trusted sector, 21 points below technology, 11 points below entertainment and even 8 points below consumer packaged goods. And while trust in banks was increasing in 15 of 26 markets, the sector was not trusted in many European Union countries, including Germany, Italy, Spain, Ireland and the Netherlands. It barely made it into the neutral range in the UK. And while the sector had made progress among the informed public, the trust gap widened between the informed and the mass public, and continued to widen. In 2020 financial services remained at the bottom of the Edelman trust barrel. In 2021 it was no longer the least trusted branch only because Edelman included the new category of social media, which the financial sector outscored by seven points while itself declining by four points.

This is somewhat discouraging in that the financial sector has been taking heart from seeing itself as "a part of the solution" rather than the origin of the problem in the COVID pandemic, and could have expected a rebound in trust. This has apparently yet to materialize.

For an industry whose stock in trade has always been trust, these are alarming numbers, especially if one reflects on the fact that the shoe has yet to drop on pandemic related insolvencies. These have been held back through an assortment of subsidies, guarantees and moratoria, all of which are due to run out in the course of 2021, bringing the possibility of a steep rise in NPLs and thus distress in the banking sector and an end to the feeling of being "part of the solution".

These are also attitudes finding increasing resonance in official publications. As an example, the OECD Business and Finance Outlook 2019, entitled "Strengthening Trust in Business" deals with the concept of "wrongdoing before the law or public opinion", without distinguishing between the law and public opinion, as a significant element in restoring or continuing to damage trust in business and finance, which it finds is once again at the front of mind for political and business leaders alike. The report cites the OECD's 2017 definition of trust as requiring that persons "operate consistently with a set of values that reflect citizens' expectations of integrity and fairness." In the 2019 report the OECD defines the basis of societal trust more clearly as resting "upon expectations that these activities will contribute to sustainable and inclusive economic growth; will not lead to imposition of losses on society through excessive risk-taking; and will be aligned with broader societal values related to environmental, social and labor, among other issues."

In 2018 the consulting firm Accenture attempted to put a dollar and cents value on what it termed "trust incidents". In a study entitled "The Bottom Line on Trust," they concluded banks were most susceptible to losses of revenue and EBITDA as a result of such incidents, with a negative impact on revenues of 21.8%, as compared to a global average for all industries surveyed of 5.8%. In an anonymized case of a "B2B Company" named in money laundering allegations it showed a decline in revenue from 2016 to 2017 of a third and a decline in EBITDA of over 60%. This should not be surprising, given the

central role played by trust for financial institutions we just noted above. So this is another area where NEDs can and should play a role and where their input would be more valuable than in detailed monitoring of compliance. With trust being the foundation of banking business, what could be a more important focus of attention for NEDs? Perhaps ESG.

Where it all comes together for NEDs: ESG

For a long time, ESG issues were considered a part of HR or investor relations, a bunch of boxes to be ticked and little more. That is no longer the case. In its 2020 Annual Corporate Directors Survey, PwC puts it's nicely: "[f]or companies, ESG is about risk, and it's about opportunity, it's about the ways in which value could be destroyed or created. Boards play a critical role in ESG oversight". The board has a unique vantage point from which it can link purpose and strategy, require consistent and reliable information, focus on the right disclosure and allocate oversight. The PwC survey shows that the percentage of corporate directors saying their company should take climate change into account in developing strategy jumped 13 points in just one year, to 67%. This percentage goes up to 79% for female directors, although even among female directors the link between ESG and enterprise risk management (ERM) is not as strong as it might be. Only 52% (43% for their male colleagues) think ESG ought to be regularly part of the board agenda, 60% see it linked to company strategy (40% for their male colleagues) and 63% think it should be part of the board's EM discussions (53% for their male colleagues). So there is still room for improvement here.

The pressure on companies to pay attention to these issues has come primarily from investors, employees, civil society and regulators and supervisors. Each of these constituencies can be expected to look to the board of directors to play a significant role in seeing that their companies are dealing with them appropriately. This would be entirely consistent with the approach to the board's role I have been proposing. Of course ESG is a very broad area, and one could argue for a differentiated approach to the three areas of environmental, social and governance issues. Governance, for example, can directly affect the board, since the issues often involve board independence, diversity and length of tenure of directors, including NEDs. Here the board will clearly have both an interest

and expertise, but may find itself conflicted. Social issues relating to questions like working conditions both within the company and within its supply chain may seem to be matters more directly in the bailiwick of management, subject to monitoring by the board, rather than to its direct participation. But as recent experience with clothing manufacturers using underpaid labor has shown, consumer reaction can have significant negative effects on the company's sales and results of operations, and thus have a considerable strategic importance.

I would put environmental issues in a category of their own, as their effect on both the opportunities and risks for the institution are particularly material. On the risk side, I think it is sufficient to say that climate is all pervasive and constitutes a non-diversifiable risk for financial institutions. For these institutions, climate related issues require important decisions to be made about their strategic direction. These can involve, as noted above, cutting off credit to companies which are particularly carbon intensive and are unwilling or unable to transition to a less carbon intensive mode of operation. Cutting off credit can damage the institution's reputation as a reliable business partner and can lead other customers to rethink long standing relationships with it. On the other hand, continuing to finance polluters can have even more serious consequences for the institution's perceived bona fides in the increasingly important area of sustainable finance. This is an area where most financial institutions see enormous upside potential. Decisions should not be lightly taken which could close off possibilities for growth for the institution and for contributing to global sustainability.

Other decisions can also involve difficult decisions about continuing to provide support to some transition activities which may smell of "greenwashing", which can also result in counterparties and investors questioning the institution's bona fides as a provider of reliably sustainable products and services. In the absence of binding standards for what is green or sustainable it can be very hard for a financial institution to prove itself and its products sustainable once their good faith has been questioned. How to navigate these dangerous waters involves decisions where advice from the board, not merely monitoring by the board would be appropriate, and where the board can play an important role in helping the institution communicate its policies and the reasons therefor to important constituencies. Among these constituencies are shareholders and other

investors. The PwC survey shows the increasing role boards are playing in relation with shareholders. In particular, the survey shows a significant increase in the percentage of director engagement with shareholders to 58%, up from 42% in 2017 and that this engagement is judged by 87% of directors to have a positive impact on proxy voting (up from 59% in 2016) and by 76% to have a positive impact on investment decisions.

Finally, it is worth noting for EU financial institutions subject to the EU Non-Financial Reporting Directive that the concept of "double materiality" is central to their duties thereunder. It requires assessing environmental issues as material if either they can influence the development, performance and position of the reporting company or if the company's activities have a material environmental or social impact. This would seem to indicate the need for significant board attention to these matters.

Conclusion

NEDs have a crucial role to play in the governance of their enterprises, but they are part-timers with limited time and attention to devote to this important role. It thus is incumbent on their enterprises to use this precious resource wisely, by enabling them to focus their attention on the areas of the business decisions where they can contribute the most. In this time of rapid and disruptive change, I suggest that these areas include in particular the environmental aspects of ESG, strategy and culture.

Patrick Kenadjian
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