Improving Bank Governance and Culture after the Global Financial Crisis

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I. Corporate Governance Reform after the GFC

II. Improving Corporate Governance of Chinese Banks

III. Towards a Better Risk Culture
A Number of Post Crisis Reforms Aimed at Improving Corporate Governance of Banks

- The Global Financial Crisis revealed key problems in corporate governance of financial institutions
- FSB has published guidelines to address governance issues
  - Principles for an Effective Risk Appetite Framework (2013)
  - Guidance on Supervisory Interaction with Financial Institutions on Risk Culture (2013)
  - Principles on Sound Compensation Practices (2009)
- BCBS has published guidelines to improve corporate and risk governance of banks
  - Corporate governance principles for banks (2015)
  - Principles for effective risk data aggregation and risk reporting (2013)
  - Core principles for effective bank supervision (2012)
Challenges Remain

● Some of the post crisis reforms have yet to be fully implemented
● Improvements in corporate governance at financial institutions have yet to be tested, as business models continue to evolve rapidly
● Recent cases of misconduct indicate significant gaps remain in governance
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Reforming Corporate Governance of Chinese Banks

- Market reforms have provided the foundations for a vibrant and dynamic banking sector
- By early 2000s, China’s major banks have established the formal corporate governance structures and processes of a modern bank
- The Company Law sets out basic provisions on the responsibilities of the board and senior management for all companies
- The CBRC has issued a number of regulatory guidelines to ensure sound governance of banks, including:
  - Guidelines on corporate governance of commercial banks (2013)
  - Guidelines on the work of the supervisory board of commercial banks (2012)
  - Guidelines on internal control of commercial banks (2014)
The CBRC has issued a number of regulatory guidelines to improve governance of Chinese banks, including:

- Guidelines on sound compensation practices at commercial banks (2010)
- Guidelines on external audit of banks (2010)
- Guidelines on the consolidated management and supervision of commercial banks (2014)
- Administrative rules on information disclosure by commercial banks (2007)
- Administrative rules on related-party transactions of commercial banks with insiders and shareholders (2004)
- Administrative rules on performance evaluation of commercial bank directors (2010)
- Administrative rules on the qualifications of directors and senior management of banks (2013)
- Internal guidelines on supervisory rating of commercial banks (2014)
The Two-tier Governance Structure of Chinese Banks

- The board of directors of a bank is ultimately responsible for corporate governance and risk governance of a bank, including:
  - Safeguarding the interest of depositors and other stakeholders
  - Approving business and development strategies and overseeing implementation
  - Risk appetite, risk management and internal control
  - Capital planning and management
  - Information disclosure and the reliability and timeliness of financial reporting
  - Approving the policies and procedures for management of conflict of interest

- The board of supervisors is responsible for supervising the board of directors and senior management, including:
  - Assessing the reasonableness of business strategies, remuneration policies
  - Assessing adequacy of risk management systems and internal controls
  - Evaluating the performance of the board of directors
Regulatory Efforts to Improve Corporate Governance

- CBRC’s expectations for sound corporate governance include:
  - A sound organizational structure with clear roles and responsibilities
  - Appropriate business strategies with a clearly articulated risk appetite framework
  - Robust corporate values and social responsibilities
  - Effective risk management and internal controls
  - A reasonable incentive and accountability framework
  - Sound information disclosure

- Enhanced requirements for large and medium banks (capital > 1 billion RMB)
  - Structure and composition of board committees
  - Qualification requirements for directors and senior management
  - Requirement for Chief Risk Officer (CRO) and Chief Information Officer (CIO) positions
  - More intensive supervisory assessment and review
Evaluation of Board of Directors

- Directors are subject to annual appraisals, including self-assessment, appraisal by the board and the supervisory board.
- Appraisal results are categorized as competent, largely competent and incompetent.
- Banks are required to replace board members deemed incompetent or unfit to carry out their responsibilities.
- Board members assessed to be largely competent must demonstrate improvement within a specified time frame.
Guidance on Compensation and Incentives

- The CBRC published the *Supervisory Guidelines on Sound Compensation of Commercial Banks (2010)*
  - Compensation should be commensurate with the bank’s strategic goals and conducive to talent development and risk control
  - Compensation should be commensurate with risk-adjusted performance and balance short term and long term incentives
  - More than 40% of performance based remuneration of senior management and material risk takers should be deferred over more than 3 years
Supervisory Review of Corporate Governance

- The CBRC assesses the quality of a bank’s corporate governance on an ongoing basis through off site review and on site examination.

- Supervisory review of corporate governance includes:
  - Observing banks’ board and board committee meetings
  - Interviews with board and senior management
  - Meetings with internal and external auditors
  - Review of documentation

- Observations and conclusions drawn from supervisory review are incorporated into the bank’s supervisory rating as an important component of management performance.

- For governance issues identified during the supervisory process, the CBRC undertakes supervisory actions to ensure that banks take remedial actions.
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The Importance of Risk Culture

● All FSB member jurisdictions report having established regulatory frameworks for effective corporate governance

● Recent high profile cases of market manipulation and fraud indicate that serious gaps in governance remain
  – “There is a significant difference between a compliance manual and what a bank employee knows is good practice”

● Many banks have not got the “soft” part of their governance right
  – For them, risk culture has yet to be fixed
The Importance of Risk Culture (Cont’d)

- Each bank has its own risk culture, developed though shared experiences of the organization over time.

- Risk culture affects the quality and effectiveness of governance in banks in a more fundamental way than formal rules.
  - It is the norms and traditions of behavior of individuals and groups at a bank that determine the way in which they identify, understand, discuss, and act on risks the bank confront.

- It is important to understand the factors which affect risk culture and how the latter interacts with the formal elements of governance to achieve the right balance in risk management.
Factors that Affect Risk Culture

- At the micro level:
  - Quality of the board and senior management
  - Vision, experience and personality of the chief executive
  - Compensation and incentive structures
  - Individual accountability

- At the macro level:
  - The robustness of legal frameworks
  - The level of moral hazard stemming from market structures
  - The degree of transparency in the financial system
  - The nature of financial regulation and the way they are enforced
Many of the Reforms are Conducive to Fostering a More Robust Risk Culture

- Efforts to end “too big to fail” will reduce moral hazard
- Efforts to strengthen the oversight of external auditors will increase transparency
- Reforms in compensation regimes will instill greater accountability of key decision makers and achieve a better balance between short term and long term incentives
- A pioneering effort to instill greater individual accountability: UK authorities introduced the Senior Managers Regime (SMR) in 2016
Linking the Letter and Spirit of Regulations with Actual Behaviors

- It is important to differentiate supervision of the formal elements of corporate governance from supervising the risk culture of a bank.
- In 2014, the FSB published the *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*.
- Most jurisdictions assess risk culture within existing risk governance, risk management and compliance frameworks.
- De Nederlandische Bank (DNB) has developed a dedicated supervisory team to assess the culture of banks.
Supervision of Risk Culture is Challenging

- A number of challenges have already emerged
  - Strike the right balance between taking a more intrusive and proactive supervisory approach and not unduly influencing strategic decisions of the bank’s management
  - Assess the appropriateness of a particular risk culture in relation to the bank’s strategy and risk appetite
  - There is currently no precise methodology to apply supervisory judgment
  - It is challenging to communicate culture problems to banks and raise awareness

- Tackling risk culture is the “final frontier” in the post-crisis response, and the supervisory community must begin to focus on it in earnest
Thank you!