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“Dedicated to Excellence in Financial Institutions”

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Dear Friends

Bank regulation and management transitions have been the major themes of our work since our last Strategist newsletter.

Our new book on effective bank regulation is due to be published as we go to press on this newsletter (in record time!) and is summarized in the lead article in this newsletter. Bank regulation is a new topic for DIBC and we look forward to learning more about best practice and sharing views with our friends in the months to come. We're deeply appreciative of the time and wisdom contributed by over 30 interviewees. The box within provides guidance on accessing copies of the book, which, unlike some of its predecessors, is priced to leap off the shelves!

Perhaps our most challenging consulting assignment was to facilitate a Board meeting with a European bank which has been nationalized as a result of the banking crisis and is developing a new strategy for the future. Another transition assignment was to prepare a management seminar for a long-standing bank client undergoing a strategic review in connection with the arrival of a new CEO. We also carried out further research for a non-EU client on the impact of the introduction of bancassurance in Europe.

Brenda Jenner has completed a total revamp of DIBC's website, which after close to 30 years has been overtaken by new technology as well as the evolution of our firm since 1979. Brenda also contributes her views on corporate governance in banking in this issue.

*Steve Davis*

## ***EFFECTIVE BANK REGULATION AND SUPERVISION: LESSONS FROM THE FINANCIAL CRISIS***

Listening to Stephen Green, Chairman of HSBC, speak on the issues of bank regulation at our last Planners Forum session generated a number of questions for me. Why did regulation fail in some national markets and not others? Was the problem in regulation or in supervision? In short, what can we learn from the recent experience of national agencies to prevent or mitigate the next banking crisis?

The result was the book profiled in the attached box and based on over 30 in-depth, off-the-record interviews with senior regulators, bankers, management consultants and rating agency executives who are deeply involved in the regulatory process. Unlike the profusion of recent books recommending new regulatory structures and measures, this simply analyses the lessons from actual recent regulatory practice which could be applied to whatever global regulatory framework evolves from the current global debate.

Very briefly, after summarizing the unique dimensions of the crisis and the proposed regulatory measures now in train, the book examines three key differentiators of bank regulation agencies: structure, professional skills, and the political environment in which they function. It then profiles nine case studies of national regulation to examine the drivers of such regulatory success or failure. It concludes with the experts' and author's views on the likely future success of bank regulation, the key factors which are likely to determine such outcomes, and steps which could improve these outcomes.

The three differentiators are as follows:

### **(1) regulatory structure:**

Our analysis of the structure of bank regulation confirms that there is no single best deployment in a given country of the central bank, Ministry of Finance, a dedicated bank supervisory authority, or other government agencies. Each approach has failed or succeeded in relative terms during the recent crisis. Yet experience has shown that the use of multiple agencies, such as a tri-partite structure, requires intense collaboration and information sharing among the agencies to succeed. Gaps and overlaps are responsible for many of the recent regulatory failures. One particular issue separates our interview sample: the practice of embedding, or permanently assigning individual supervisors to specific banks, as is the practice in the US, Spain and UK. A number of our interviewees felt strongly that such a practice was both inefficient – in separating supervisors from central policy direction – as well as encouraging so-called 'regulatory capture' - the suborning of supervisors to the views of the bank they are supervising.

### **(2) professional skills:**

As for professional skills, it is widely agreed that the central bank and Ministry of Finance usually have the advantage of sound macroeconomic reputation and the ability to attract superior brainpower in the local market, but they often lack

*Continued overleaf*

the practical understanding of banking needed to identify and address key risk issues. On the other hand, specialist prudential agencies have the necessary contact with the banks but often give priority to administrative oversight, consumer protection, and other tasks rather than the central issue of detecting and addressing systemic and individual risk issues. It is widely agreed that work overload and the lack of guidance on supervisory priorities are a problem in many agencies in the US, UK and other markets.

There is widespread agreement that the missing skills link is often bridging the gap between the brainpower needed to identify and analyse macro-prudential problems and the micro skills needed to understand the banking business and how to relate this analysis to the real banking world. The problem may thus not be regulation or supervision, but the skills which bridge the macro and micro worlds.

Finally, the mandate – ideally to detect macro and micro risks – is often not totally clear to those entrusted with its execution, where in other cases additional mandates – audit, compliance, consumer protection, and others – complicate the task of the banking supervisor.

### (3) political pressure:

The issue of political pressure and interference with the regulatory process is a significant one in a number of markets where voters can influence the legislative process so as to defend the perceived interests of a portion of the banking system. This is the case in three case studies examined: the US, Spain and Germany. Many observers thus view ‘politics’ as one of the most serious unresolved issues in effective bank regulation. One of the few solutions is to increase the political credibility of the bank regulator to a par with the central bank or other agency charged with macroeconomic regulation.

### • The case studies

The case studies profiled in the book include six (Canada, Spain, Australia, Norway, France and Italy) which have emerged from the crisis with a relatively successful track record in identifying systemic issues and taking pro-active intervention measures to address these issues. Not surprisingly, many of these are dedicated supervisory agencies created as a result of the previous banking crisis in the 1990s and presumably benefiting from the experience as well as credibility obtained in that period. The Bank of Spain has gained credibility in obliging banks to create over-the-cycle loss reserves as well as providing capital for SIVs (off balance sheet vehicles). Others like OSFI in Canada, APRA in Australia and the FSA in Norway insisted on capital provisions and other benchmarks well above the minimum standards.

In contrast, the examples of the US, Germany and the UK demonstrate the issues of regulatory gaps, dilution of focus on risk assessment and political intervention in the regulatory process.

### • Conclusions and outlook

As for the outlook for bank regulation, our sources generally agreed that future crises are inevitable. The unpredictability of the source of future systemic problems, the frequent influence of politics in the process, and the mixed track record of actually implementing the long-established supervisory responsibility incorporated in Pillar 2 of the current Basel framework – all point to the conclusion that bank regulation can only be expected to mitigate, not prevent, future banking problems.

Interviewees involved in the current EU discussions on future regulatory measures acknowledge, for example, that the ‘law of unintended consequences’, in the form of practitioner action to avoid new measures, is very much on the minds of such bodies. At the same time, the actual reliance on Pillar 2 measures during the crisis varied widely across jurisdictions, with the French and

Italian supervisors, for example, actively and successfully deploying such interventions, while in the US and UK they were not even on the agenda.

### • Possible action steps

The recent crisis has, however, pointed up a number of steps which can improve regulatory effectiveness in the future. Thus improved collaboration among multiple agencies is one. While this may be difficult in the critical US market, it may be more effective in Germany or the UK, where a possible merger with the central bank is on the political agenda.

At the time of writing, the outline of a future global regulatory framework is unclear at best. But whatever the outcome, most of our sources concur in the primacy of simple, ‘old fashioned’ measures such as focus on a few key metrics like capital adequacy and liquidity, as well as the importance of inspection, close contact between bank CEOs and their regulatory counterparts and, most difficult of all, pro-active intervention by the regulator as appropriate. On the other hand, there is less confidence in the structural measures recently proposed to limit the size and profile of banks as well as compensation levels.

In conclusion, the issues of regulatory structure and adequacy of professional skills can be addressed with relative ease by a determined agency, while that of political interference in a democratic environment can perhaps only be dealt with by improving the public’s confidence in the regulatory mechanism as has occurred in the macroeconomic management in many countries over the past few decades. Taking the punch bowl away from the party will always be a difficult task, but our case studies of success during the crisis in the use of the existing Pillar 2 guidelines demonstrate that it can be done!

*Steve Davis*

# *Effective Bank Regulation & Supervision: Lessons from the Financial Crisis*

*by Steven I Davis*

*A new and unique insider view of what actually works, what ought to work, what prevents it from working, and what needs to be done about it – industry experts who have to implement and work within regulatory systems give the real best practice picture*

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## **GOVERNANCE: WHAT DOES IT MEAN AND WHAT IS ITS RELEVANCE TODAY FOR FINANCIAL INSTITUTIONS**

The last two to three years have seen the emergence of the term “governance” even as a headline, but do we know what it really means and what its relevance is to financial institutions today and in the future?

Regulated industries are now having governance included to a greater or lesser extent within the standards or benchmarks against which their regulators are judging them. The official definition of governance, according to the Oxford English Dictionary is ....*the action or manner of governing; method of management, system of regulations; mode of living, behaviour, demeanour.*”

I cannot tell you whether that is helpful or not but I think it does say that this is a term now used for something which we all recognise and understand, namely management.

For me the key issues are: 1) the regulators are now involved; 2) we have actually forgotten what our behaviour should be; and 3) what we should be doing about it.

I would like to first address the regulator issue. For more than twenty years, there has been discussion about codes of practice in the governance area. Over the last three years, every professional magazine you pick up seems to have a regular article about governance, what it is and how to do it better. The regulators across the industry spectrum are including governance as one of their key lines of enquiry as they assess organisations.

So how do we decide how to govern? Well, in theory, that has been made much easier too. But it is also confusing. In the UK alone, there are at least 25 different codes of governance. The most well-known code – and probably the first official code – is the Cadbury Code. But there are many others, most of which are industry or service specific. The Walker Review was undertaken in 2009 of the corporate governance of banks and financial institutions. To give a better feel for what these reviews cover and the possible requirements of regulators, I list below some of the elements of the table of contents of The Walker Review:

- **Role and constitution of the board:**

- roles of executive vs. non-executive directors
- statutory and other foundations of the board

- **Board size, composition and qualification**

- the actual size and how it “looks”
- required experiences and competencies
- induction, training & development

- **Functioning of the Board and evaluation**

- **Governance of risk:**

- risk strategy
- independence of risk function
- role of the board risk committee
- risk disclosure and risk governance

- **Remuneration**

So why spell this out? Because it is my belief that lack of good governance has forced regulators, across a wide range of industries and activities, to start spelling out specific ground rules. My view is that this can be detrimental to the proper running and management of a business. The governance of a firm or company becomes a “satisfy the regulator” exercise rather than a model of good “behaviour or demeanour” as the definition says.

So have we forgotten what our behaviour should be? I think that regardless of the industry we must seriously consider our stakeholders and what their expectations of us are and how we act. In the case of the banking industry, much has been made over the last three years of its stakeholders. But I think it is worth repeating who they are: 1) customers – retail and corporate, charities, etc. and looking at the asset and the liability side of the balance sheet; 2) shareholders and other investors; 3) employees; and perhaps even 4) the regulators. All entities have a strategy; some of these are better articulated than others. But whatever the strategy, it needs to reflect the requirements of the stakeholders and it should also be

reflected in the governance of the company. I would suggest that perhaps the industry's governance has lost the ability, maybe even the willingness to "behave" in a manner which properly reflects the needs of the stakeholders and which forces the "governance" group to ensure that its strategy is consistent with this and is monitored accordingly.

I trust no one reading this will think I am speaking heresy! However, it is my view that in the future – and particularly if we want to retain independence and flexibility – we must ensure that we "govern" our organisations in a way which is consistent with these underlying premises, regardless of the governance

code which each organisation decides to adopt.

This I think is where started and should end, namely that "governance" is just another word for management and that as "managers" we look hard at ourselves individually and a group and ask whether we are being true to the behaviour which is appropriate for our organisation and its stakeholders, and are we managing in a manner which is consistent with our strategy and can be seen as "good behaviour". Finally, as managers and part of the core governance of a financial institution we should lead from the front and be strong in our determination!

*Brenda Jenner*

# An invitation to the International Bank Planners' Forum

The International Bank Planners' Forum (IBPF) was formed in 1990 at the instigation of DIBC. The Forum provides an opportunity for key individuals charged with the strategic development of their financial institutions to meet to discuss and debate issues of common interest. The membership consists of leading banking institutions in Europe and the US.

The next meeting is scheduled to take place on Thursday 6th and Friday 7th May 2010. The Friday session which is open to non-members comprises the following agenda:

- Summary of current trends and issues in banking  
*Steven I Davis, DIBC*
- Addressing the regulatory issues: the view of a senior banker  
*Mark Garvin, Chairman, Treasury & Securities Services - International, JPMorgan,*
- The outlook for European banking as seen by a top banking analyst  
*Simon Samuels, Head of Banks Equity Research, Barclays Capital*
- The future of banking  
*Pat Butler, Director, McKinsey & Co*
- Panel discussion between among speakers and guests

***And a note for your diaries: the November Planners meeting is Friday 12th November***

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