



Boards' efficiency and fit & proper rules in financial organizations

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ecoDa/EBF Joint conference

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SUMMARY REPORT

In May 2017 the European Central Bank published a guide on the “fit and proper assessments” undertaken with respect to the board members of the institutions under its direct supervision. Similarly, the European Banking Authority (EBA), in cooperation with the European Securities and Markets Authority (ESMA), issued joint guidelines aimed at further harmonizing the assessment of suitability within the EU financial sector. The EBA also issued additional guidelines aimed at ensuring sound governance arrangements in all financial institutions.

On the basis of these developments, on Wednesday 25 October 2017, the European Confederation of Directors' Associations (ecoDa) and the European Banking Federation (EBF) organized a joint event on “Boards' efficiency and fit & proper rules in financial organizations” in Brussels.

The conference focused on boards' effectiveness as a key challenge going beyond structural elements such as board's composition and the definition of members' roles and responsibilities. In fact, according to all speakers, an essential driver of efficiency lies in board's dynamics, where independence and professionalism play a crucial role. More specifically, during the conference the speakers wondered:

- how the fitting of an individual board member should be evaluated in light of the composition of the global board,
- how often and insofar should board assessments be conducted and,
- how should supervisors complement the role of boards in assessing the suitability of directors before any (re-)nomination.

After a welcoming speech by **Sébastien de Brouwer**, Chief Policy Officer at the European Banking Federation, two keynote speeches were made by

- **Margarita Delgado**, Deputy Director General at the European Central Bank and
- **Bernd Rummel**, Principal Policy Expert at the European Banking Authority.

According to **Margarita Delgado**, sound governance and risk management arrangements are two crucial elements in the currently changing financial landscape. Yet, adequate composition and effective organization of the management body of financial institutions are essential too. For this reason, the ECB has reviewed the organization, composition and functioning of the Supervisory/ Management

Board. Additionally, Joint Supervisory Teams have also analysed in detail, for a subset of banks, the compliance with the best principles on risk data aggregation and risk reporting (BCBS 239). Furthermore, the ECB assesses on a regular basis within the FAP process and analyses the independence, collective knowledge, conflicts of interest, and succession planning, by conducting interviews for fit and proper analysis.

In **Bernd Rummel's** opinion, EBA/ESMA guidelines provide a useful framework to assess suitability, which is to be applied proportionally. At all time, the board has to be suitable. In order to assess the suitability of board members, supervisors and financial institutions need to reflect on institutions business models and strategies as to identify the knowledge and experience needed by board members individually and collectively. The board's assessment should not be reduced to a tick boxing exercise, but needs to reflect the specific situation of the institution and its board members. One needs to differentiate between the executive members that direct the business and the supervisory function, which is also supposed to fully understand the business of their financial institutions and should constructively challenge decisions to be taken and strategies to be set. The importance of training should not be underestimated in the fast developing financial sector; induction and training sessions are considered to be vital tools to ensure sufficient individual and collective knowledge. It is crucial that the board collectively has the expertise for all business areas; for this assessment the EBA developed with its suitability matrix a comprehensive assessment tool. The board also must commit sufficient time for its tasks. Board members should be able to attend all meetings and be well-prepared. While diversity is not a hard suitability criterion, diverse boards with members that have different risk appetites, cultures, and backgrounds lead to better board dynamics. Another good practice for boards is having independent directors that have no close personal or business relationships towards the institution or other members. However, all members have to be independent of mind, to be understood as a question of skills and behaviour. Existing conflicts of interests have always to be managed. Consequently the EBA guidelines on internal governance require the implementation of a conflict of interest policy.



The conference went on with a panel discussion among seven speakers:

- **Mar Cachà**, Head of Division of Authorizations and Registration of entities at the Central Bank of Spain,
- **Frédéric Hervo**, Director for international affairs at the Autorité de contrôle prudentiel et de résolution (ACPR),
- **Dr. Peter Lutz**, Director for Banking Supervision at BaFin (German Federal Supervisory Authority),
- **Prof. Lutgart Van den Berghe**, Executive Director at Guberna, Chair of EcoDa Policy Committee,
- **Luc Frieden**, Chairman of Banque Internationale in Luxembourg,
- **Caroline Veris**, Partner Deloitte, FSI Governance and regulatory affairs, and
- **Christophe Vandoorne**, Managing Partner Korn Ferry Belgium.

The debate was moderated by **Paola Schwizer**, Chair of Nedcommunity and ecoDa board member.

The first speaker, **Mar Cachá**, elaborated on the challenges met by the Central Bank of Spain during the implementation of EBA guidelines that still is work in progress. The main difference is that the scope of BE assessment is wider than the one of EBA guidelines: it applies to all credit institution and to all senior managers. If it is decided to change, it will mean changing a law which is always complex. In addition to this, Mar Cachá reported that the Central Bank of Spain practices ex ante assessments, organizes interviews with chairs and CEOs and includes all board members in a register. Moreover, the Central Bank of Spain relies on an advisory committee composed of retired lawyers with a legally non-binding, but still influencing, opinion to help with the assessment of good repute.

According to the second speaker, **Frédéric Hervo**, both Guidelines are useful to establish harmonized criteria for the assessment of the suitability of the management body and to ensure sound governance arrangements. This builds upon the lessons of the last financial crisis which has shown significant weaknesses in corporate governance.

The changes that have been made to take into account the outcome of the public consultation are welcome and will facilitate the implementation of the guidelines. In particular, the final version of the guidelines clearly state their neutrality with respect to the different models of governance and better take into account important aspects for savings banks or mutual banks.

In terms of implementation, the national authorities, including ACPR, will have to notify ESAs whether they comply or intend to comply with the guidelines, or otherwise the reasons for non-compliance ("comply or explain" procedure). This is expected to take place early next year when the translation of the guidelines in national languages is available. It has to be emphasised that the guidelines leave the competent supervisory authority the assessment of a number of important topics, including the appropriate number of independent members in the governance bodies of listed institutions, taking into account the proportionality principle. For significant institutions within the SSM scope, the ECB will be the implementation authority. Regarding possible challenges for implementing the guidelines, one of the difficulties is the extension of the scope of the fit & proper assessments to the so-called "key functions holders", which is not explicitly provided in CRDIV. Another challenge is that the guidelines enter into force relatively shortly (30 June 2018). This requires preparation by institutions and authorities to integrate these guidelines into their internal procedures.

The third speaker, **Dr. Peter Lutz**, argued that in a two tier system the level of requirements should slightly differ between the management and the supervisory board. The supervisory board serves the purpose to deal with the agency issue, since owners are neither able to run the bank nor to supervise it. According to Peter Lutz, a one-to-one implementation of the new EBA/ESMA guidelines could require more resources, also in terms of interviews. However, taking into account the high number of banks in Germany BaFin does not intend to interview each board member. Therefore, it will apply a proportionality rule and conduct interviews only depending on significance. In reference to boards, the Federal Financial Supervisory Authority still owns the power to dismiss unsuitable board members. Nevertheless, in Peter Lutz' opinion some legal changes might be necessary. In fact, more and more often banks look for specialists whereas the legal requirement of collective responsibility demands executive members to be fully skilled.

According to **Luc Frieden**, "in order to chair a bank, you don't need to be a technician". It is not essential to be able to understand every detail neither: adequacy of skills is what really matters within a board. Similarly, diversity represents a key feature for an efficient board. However, the board should not

allocate specific missions to anyone. Furthermore, in the view of Luc Frieden, being a chair of a supervisory board is different from being a CEO. The chair has to refrain from interfering with the daily management of the chair is supposed to operate as a coach. In this context, boards have to understand the framework. As already mentioned by Bernd Rummel, Luc Frieden underlined once again the importance of training in a complex world, even though organizing afternoon sessions with experts on specific topics is still quite unusual. In addition to this, the speaker pointed out the fact that the EBA/ESMA guidance does not distinguish between parent companies and subsidiaries and stressed the difficulties in assessing time commitment of people since this requires an exercise of trust. According to Luc Frieden, the EBA/ESMA guidance is about common sense. When minutes are too detailed, people refrain from speaking; formal meetings have to be documented but people need to express themselves freely in other fora (similar to cabinet meetings).

Lutgart Van den Berghe wondered if the Fit & Proper test actually leads to better boards and if the concepts are robust enough. Lutgart Van den Berghe congratulated EBA/ESMA for the guidance, useful not only for financial but also non-financial institutions. Nevertheless, she argued that the guidance on collective suitability should be complemented with some further analysis of board decision making and board dynamics. According to Lutgart Van den Berghe, each individual member of a board plays an essential role, but one should never forget that boards operate as a college and wisdom of crowd is even more important at the helm of a company. Indeed, when it comes to achieving efficiency, board dynamics is what counts the most. Therefore, a critical internal board assessment is an essential complement to external supervision. Both are important: external analysis alone is insufficient because you can't judge board decision-making nor on paper neither by attending board meetings as external supervisors. To foster robust board assessments, here again, a minimum number of independent non-executives should be reached in order to help boards act in a real independent way. However, she fully agrees with the EBA guidelines that every board member should behave independently in the best interest of the company (independence of mind). Furthermore, Lutgart Van den Berghe fears that time commitment cannot be easily compared. Again the EBA did a great job in nuancing the analysis of professional mandates between a commercial and a non-profit organization. Thus, national supervisory authorities need to find the right balance, stop relying only on minutes as judging tools, applying proportionality wherever relevant. To make board assessments more robust, not more but less frequent evaluation exercises are preferable. Indeed, in order to avoid superficial evaluations, such evaluations should be carried out every 3 years, with in between updates on action plans and execution of continuous improvements. Finally, committees should not be treated in the same way as the full board. She concluded by stating that boards also have a role to play to foster business development. The supervisors have to acknowledge that to make business, 'some' risk has to be taken. If one doesn't do business, he/she doesn't take risks, but at the same time he/she will be no longer in business.

According to **Caroline Veris**, boards should be neither too large nor too small. The competences required within the boardroom depends on its activity. Yet, external experts can always be added and induction trainings should be organized for all board members. With regard to training, simple things like a company's glossary on terminologies can be very useful. It is important to create a pipeline of fellow directors, being however aware of they might be in a conflicted position when a position is open. In Caroline Veris' view, the EBA/ESAMA guidance provides useful insights on independence in form and in mind and on conflicts of interest. Performing in depth analysis on potential conflicts of interest and the management thereof is becoming a standard good practice. As regards to board meetings, the

speaker highlighted the importance of the quality of documentation, the balance between monitoring and strategic topics and the allocation of sufficient time for the discussion of topics.

The last speaker, **Christophe Vandoorne**, talked about the passage from co-optation of friends to boards of experts. He questioned the real added value of all the experts and called for smaller boards. According to him, soft skills, including experience, competences, negotiation skills, personality, and authenticity, should be judged - as it happens in the executive world - through the use of interviews, reference checks, and assessments. However, when joining a board, directors should also be aware of what drives their willingness to be part of the team. Eventually, Christophe Vandoorne argued that boards which are not well-rolling would better to address an external advisor.

The conference ended with **Salla Saastamoinen**, Director for Civil and Commercial Justice at DG Justice and Consumers of the European Commission, who welcomed the EBA/ESMA guidelines as tool supporting the implementation of the CRD. She then referred to the 2018 EC Work Programme, which announces an Action Plan on sustainable finance. Besides this, the European Commission is about to issue a public consultation on sustainability and investors' duties (in particular on the interplay between governance, sustainability, and the role of boards). In conclusion, she reaffirmed diversity as a very important concept for DG Justice that was mentioned many times throughout the conference: diversity, especially in terms of fundamental tool to avoid group thinking.


