Some Reflections on Bank Governance and the Banking Crisis

Jim O'Leary
(NUI-Maynooth)

Introduction

From 2002 to 2008 I served as a non-executive director of AIB. For most of my term I was a member of the board's audit and remuneration committees. From 2007 to 2009 I was also a member of the supervisory board of AIB's Polish subsidiary BZWBK.

My former association with AIB places me in an interesting but difficult position when it comes to contributing to a discussion like the one we're having this afternoon. Many of my insights come from my experience as an AIB director, but I don't consider myself to be at liberty to reveal details about decisions made by the AIB board.

It's inevitable that what I have to say betrays some sympathy for the position of non-executive directors. One doesn't spend six or seven years in that role without developing a keen understanding of the constraints within which non-executive directors operate and the (mostly) conscientious efforts they make to fulfil their duties.

Having said all that, I am not speaking today on behalf of anyone but myself. Nor is it my intention to present an apologia for banks or their boards. Serious mistakes were made by banks during the boom years, the consequences of those mistakes have been horrendous, and the primary responsibility for those mistakes lies with banks and their boards. Nothing that I have to say is designed to evade or downplay that responsibility.

The main purpose of my remarks is to shed light on, if not fully answer two questions. First, how can bank boards, groups of intelligent, experienced people, many of whom had earned big reputations for wisdom and sound judgement, have presided over institutions that committed such disastrous errors? Second, what changes might be made to the way banks are run in order to minimise the risk that recent experience will be repeated? The first set of remarks is a good deal more extensive than the second.

Finally, I make no claim that what follows is a comprehensive review of failings in bank governance or the causes of such failings. No doubt there are some important issues that I haven't touched on. In part, this is due to the fact that I've mostly steered away from institution-specific matters, especially those not in the public domain.

Trust and management

A critical impediment to be overcome in the delivery of good corporate governance outcomes is asymmetry of information. Put crudely, the starting position is that a company's managers possess all the relevant information while the board or at least the

non-executive directors have none. Ultimately, the board is given as much information as management is prepared to share with it.

By information, I don't just mean raw data; I also mean the wherewithal to interpret the data intelligently. Nor do I mean only the kind of information that is amenable to quantification or communication in discrete form. Some information that is crucially important to understanding how a firm operates, information for example about the culture of the firm or about the quality of personal relationships within it, can only be gleaned by continuous observation over a protracted period of time. This sort of engagement is not possible for a non-executive director. Thus, even in a setting where management is relatively open and where boards are enabled to comprehend the relatively large amount of shared data, there will be potentially important gaps in the information that directors have.

The existence of the asymmetric information problem means that trust is crucial and I would suggest that, in an important sense, trust is a big part of the answer to the first of the questions set out above. Pressed to identify the overarching reason for bank boards going with the flow during the boom years, I would say that it was that the directors placed too much trust in management.

This is not offered as a formula for exonerating boards. Boards of directors are ultimately responsible for the running of the business. The fact that they delegate the task to management, does not change that, but it does mean that the exercise of judgement in the matter of who to trust and to what degree is an absolutely critical aspect of the non-executive director's role. Besides, a reserved power of boards is the appointment of the chief executive officer, probably the single most important decision a board will take.

Given their dependence on the information flow coming from management, non-executive directors spend a good deal of their time assessing the trustworthiness of the executives. The more evidence there is that the executives are open and truthful, are lucid in their presentations and display a command of detail, the more they will be trusted. And, because boards cannot always directly observe how well a company is being run and, in particular, whether a company is being run in a sustainable way, there is a tendency to use indicators of management trustworthiness as proxy measures.

Clearly, there is a potential pitfall here. An open, truthful and articulate management team is not necessarily a management team that is running the business well. Non-executive directors need to be especially mindful of the potentially disarming effect that these admirable qualities have.

Risk systems

The distinction between a company doing well and a company doing sustainably well is critical. In a banking context, the link between the two dimensions of performance is risk. During the boom years, banks performed spectacularly well in terms of profits and share price growth (and this, of course, reinforced the confidence of boards in management). It is now clear of course that this performance was bought at the cost of greatly excessive risk-taking.

Was the scale of risk-taking such as to be reckless? Looking back from a point in the middle of the wreckage, recklessness seems like a reasonable word to use but, of course, this is hindsight bias at work. With hindsight, it is tempting to conclude that the catastrophe we are now dealing with was the inevitable consequence of the credit boom that preceded it. It is but a small step from this proposition to the proposition that those who drove the growth in credit did so in the knowledge that their actions would have disastrous consequences, and thus displayed reckless disregard for the risks they were taking.

But that is not the way the future looked at the time. The prevailing belief during the boom, in bank board rooms as in the wider population, was that the boom would give way to the much-vaunted 'soft landing'. Of course, directors understood that a much more malign scenario was possible, but they trusted that the systems for measuring, monitoring and controlling risk that had been put in place ensured that banks would be adequately protected if such circumstances arose.

This confidence in risk systems had to do in part with the amount of time devoted to risk-related matters by banks and their boards throughout the boom. This was particularly the case at AIB. The Rusnak debacle in 2002 had focused attention on deficiencies in the bank's risk architecture, and ushered in a period during which extraordinary efforts were made to transform the way in which the bank dealt with risk and the board's agenda was thickly populated with risk-related items. This almost certainly conditioned non-executives to believe that the general matter of risk was being well looked after.

What about the more specific matter of credit risk and the related issue of capital adequacy? Again, in this area there was an enormous amount of work going on in banks, particularly in the latter years of the boom, thanks to Basel 2. The programme of work carried out under the auspices of Basel 2 involved a detailed, sophisticated modelling of credit risk by people with considerable technical expertise. The models developed required the approval of the regulators and, presumably to pass muster with them, were subjected to rigorous critical scrutiny by another group of technical experts.

Again, I should emphasise that I'm not endeavouring to get boards off the hook by blaming risk systems. Systems are designed and operated by people, and bank directors had an explicit role in approving risk management policies and in monitoring and reviewing risk management activities and controls. But, a major weakness of bank governance as practised during the boom years is that boards were not adequately equipped to effectively execute this role even if they spent a good deal of time addressing (or, more accurately, being addressed on) these matters. In particular, boards lacked the resources to independently evaluate the adequacy of risk systems.

Stress testing

As already mentioned, during the boom, the dominant belief amongst bank directors was that the economy would achieve a 'soft landing', defined from a property market point of view as a situation where values would plateau or fall modestly. Amongst the considerations that I believe were influential in shaping this judgement were (i) the idea that Ireland's demographics, in particular its population structure and its ability to

continue attracting immigrants, would provide an underpinning for housing demand, and (ii) the perception that the economy and the housing market in particular had shown a resilience in weathering the recession of 2001-02 which augured well for its robustness in the face of future shocks.

Even amongst those of us who were sceptical of these arguments and mistrustful of the reassurance taken from them (and I include myself in that number), the conviction that a collapse in house prices was likely was not strong and certainly not strong enough to change the opinion of colleagues. Undoubtedly the sceptics could have and, with the benefit of hindsight, should have articulated their doubts more insistently. Whether this would have made much difference is something we will never know, but it is a matter of profound personal regret to me that I wasn't more forceful in setting out the contrarian view and didn't work harder at analysing its implications.

Reflecting the prevailing wisdom, banks made the 'soft landing' their central case in designing strategy and guiding lending policies. But, mindful of the risk that something worse might eventuate, they carried out stress tests that purported to quantify the effects on profitability and on balance sheets of things going badly wrong. Almost without exception, these stress tests provided assurance that the banks would continue to make profits (albeit greatly diminished) and would remain adequately capitalised and liquid.

From a methodological point of view, we now know that these stress tests were seriously flawed. In the first instance, even the worst case scenarios tested were nowhere near bad enough. A fairly typical set of assumptions used to generate such a scenario had GNP flat-lining (compared with the 14% drop that occurred between 2007 and 2009); house completions falling by 50% (compared with an actual fall of 85% since 2006) and unemployment peaking at 11% (compared with the 13.5% rate that has already been reached). Second, the models used greatly underestimated the consequences of a given large negative shock because, *inter alia*, they didn't adequately capture second-round or knock-on effects. Third, the models made no attempt (that I know of) to capture the effects of Irish banks facing the kind of severe funding problems they have encountered on international credit markets.

These flaws point to gravely deficient risk measurement. It was not that Irish banks were recklessly indifferent to risk; it was more a case that they didn't understand the risks they were taking and were not much assisted in doing so by the tools they were using..

Countering myopia

In any event there is no doubt that bankers tend to take excessive risks during booms. Part of the explanation is that they suffer from myopia, a condition that they share with many other people. A particular form of myopia that bankers (and others) are susceptible to is what's called 'disaster myopia', the increasing tendency to discount the probability of a disaster occurring the longer the interval of time that has elapsed since a disaster last occurred.

The tendency to myopia and excessive risk-taking is almost certainly reinforced by competitive pressure. The day-to-day business of dealing with the threat from

competitors and of defending or increasing market share is real, but disaster is an abstraction until it breaks.

It could be argued that a fundamental purpose of a bank board is to protect the bank from the myopia of bankers. Ensuring that a robust risk architecture is designed and implemented is an essential part of such a mission. More generally, insisting that the longer-term and strategic implications of a proposed course of action are fully taken into account before proceeding is another. The evidence suggests that the boards of Irish banks failed badly on this score. Too many management proposals were adopted in response to arguments that were couched primarily in terms of what competitors were doing. This line of argument should have been more vigorously challenged.

An obvious way in which the myopia of bankers can be either aggravated or mitigated is through remuneration policy, and bank remuneration has rightly come under a critical spotlight. Popular commentary has concluded that personal greed was an important causal factor in the crisis (though I don't believe greed or any other human frailties are more common amongst bank executives that among business executives generally). To discern what role greed might have played, it is necessary to distinguish between two dimensions: remuneration levels and the composition of remuneration packages. My own view, for what it's worth, is that popular commentary is driven more by the former, whereas it's the latter that matters from the point of view of incentives.

During the boom years, it was common for top bank executives in Ireland to be awarded annual remuneration packages worth several millions of euro. In the eyes of many people, remuneration levels on this scale are scandalous and simply cannot be justified.

The justification used by bank boards was that such remuneration packages were required to match the market and remain competitive, and much time and effort was typically expended on unearthing information about pay practices amongst peer companies in order to establish what the market rates were. Remuneration consultants were appointed to carry out such research. The thought that the dynamic released by this kind of endeavour was somewhat akin to a dog chasing its own tail did not much diminish the earnestness with which the research results were parsed and analysed. The risks of losing a key senior figure or alienating able and ambitious young executives because of an overly parsimonious stance on pay were perceived to be too big to take.

However the need to match the market can only be regarded as a proximate justification for very high pay levels. The ultimate justification for remuneration packages amounting to high double-digit multiples of the average industrial wage has to be that the recipients are extraordinarily valuable in terms of the rare combination of talents that they bring to their posts and deploy to the benefit of shareholders. This proposition is surely one of the clearest casualties of the financial crisis. With the benefit of hindsight, it is hard to avoid the conclusion that senior bankers were seriously overpaid in the boom years.

The point I'm making here has, I believe, a more general application. Greed may be useful, but only up to the point where the outcomes are sustainable. Vast income differentials are politically and socially sustainable in a democratic society only in circumstances where a rising tide is lifting all, or at least most boats. There is a kind of social contract implicit in the acceptance of marked income inequality. If those at

the top perform incompetently, and more particularly preside over outcomes that are destructive of the welfare of the general population, the terms of that contract are broken. A significant compression of income differentials is I believe an inevitable consequence. If this is not achieved by market forces, there will be pressure on government to bring it about through the tax system.

Turning to the issue of composition, the remuneration packages of senior bank executives has typically included as the principal elements a basic salary, a performance-related bonus and some sort of long-term incentive component. Criticism has been sharply focused on the bonus element on the grounds that it incentivised bankers to pursue short-term profits without adequate regard to the long-term sustainability of those profits.

Bank remuneration committees were alive to this risk and sought to mitigate it in a number of ways. For example, it was not unusual for the payment of a significant fraction of performance-related bonuses to be deferred for a number of years. Another mitigant that was utilised was to define performance in a way that made some adjustment for risk.

Yet another means of addressing the risk posed by short-term performance-related bonuses was to implement longer-term incentive plans under which executives were granted potentially large amounts of shares in the company provided certain thresholds relating to share price performance over a multi-year period (usually 3-5 years) were reached. A critical question in the design of such mechanisms is how demanding the thresholds should be. If they're made too demanding, it may become clear to the executives at an early stage in the vesting period that the trigger point is not going to be reached, in which case the mechanism loses its purpose and the short-term bonus element in the overall remuneration package assumes a much greater relative importance than was initially intended.

This is an example of a well-intentioned measure that can fail. Overall, it would have been better to have had much smaller short-term performance-related bonuses balanced by long-term incentive mechanisms with less demanding performance thresholds.

What is to be done?

The comprehensive failure of the existing system of bank governance to prevent the current crisis poses some big questions. Does the existing system (unitary boards of directors elected by shareholders) need to be entirely replaced? More fundamentally, is the current crisis to be seen as the outcome, not of institutional failure or deficiencies of organisation, but of human behaviours that will not be greatly changed, much less eradicated, by the kind of reforms that are feasible in a liberal democracy?

I pose these questions, not because I intend to offer answers to them, but because they draw attention to the possibility that the problem may not have an enduring solution. In the matter of financial crises, history repeats itself again and again and again, as attested to by Reinhart and Rogoff's recently published and masterful historical study *This Time Is Different.*

On a rather more optimistic note, the most powerful defence against a repeat of the current crisis, at least in the medium term (by which I mean a generation or so), is the fact

that it has just occurred. The crisis and its consequences will live on in the memory of borrowers and lenders, and will loom large in the risk models of the latter, for many years to come. The result will be much greater risk aversion (and much more highly-priced risk) than obtained in the boom years.

This highlights an important danger in the current climate, namely that in an attempt to solve yesterday's problem (excessive risk-taking) policy-makers will exacerbate tomorrow's (excessive risk aversion). Reforms designed to improve the system's capacity to deal with risk need to be designed with this danger very firmly in mind.

Is there a set of reforms to the existing system of governance that offers the prospect of a decisive improvement in the way banks are run? A number of reports published over the past year or so have put forward proposals to this end which I don't intend to review in detail. Instead, I will offer a few high level comments and focus on some of the more salient ideas.

I think the most important of the proposals attempt in one form or another to ameliorate the problem that I identified earlier as a key challenge to good corporate governance, namely asymmetry of information, defined to include not only access to raw data but also the capacity to analyse and interpret them. In this regard, proposals (i) that boards have more members with banking and finance experience, (ii) that induction, training and development of non-executive members be greatly strengthened and (iii) that non-executives have access to specialist advice independent of bank management, make a lot of sense.

There is a great deal of scope for enhancing arrangements around the governance of risk. Amongst the proposals that have been put forward here are (i) the establishment of board risk committees, separate from the audit committee, (ii) putting the position of Chief Risk Officer on the same kind of footing as the Head of Internal Audit in terms of reporting lines, tenure and independence, and arrangements for determining remuneration, and (iii) enabling/encouraging board risk committees to access external sources of analysis and advice as needed. Again, these make a good deal of sense.

Another area that has attracted proposals for reform is remuneration, including increased use of deferral of incentive payments, risk adjustment of performance objectives, increased 'reach' of remuneration committees to include executives not typically within their purview up to now, and provision for clawing back bonus payments in certain circumstances.

Advocates of such reforms however are careful to point out that changes in prescribed standards and procedures on their own will not be sufficient to bring about improvements in governance. Sir David Walker, author of last year's Walker Review of corporate governance in UK banks, is worth quoting in this regard:

"…improvement in corporate governance will require behavioural change in an array of closely related areas in which prescribed standards and processes play a necessary but insufficient part. Board conformity with laid down procedures, such as those for enhanced risk oversight, will not alone provide better corporate governance overall if the chairman is weak, if the composition and dynamic of the board is inadequate and if there

is unsatisfactory or no engagement with major owners.”

To which I would add the observation that better corporate governance will not be achieved if non-executive directors do not possess the attribute which above all others is supposed to define them, namely independence of mind, and the courage to demonstrate it.

20th July 2010
Macgill Summer School
Glenties
Co Donegal