

A NEW PARADIGM

Financial Institution Boards and Supervisors



Group of Thirty

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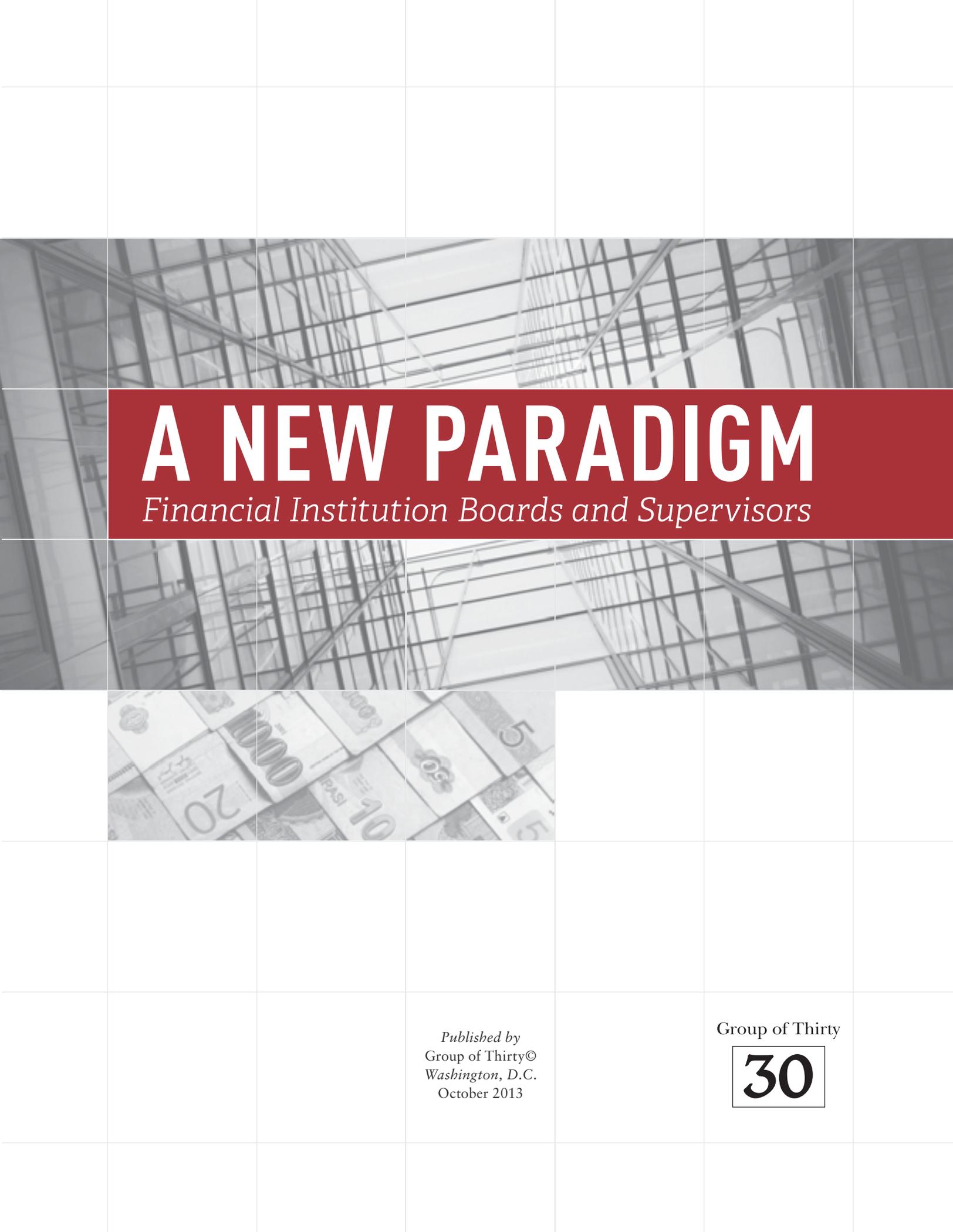
The Group of Thirty

1726 M Street, N.W., Suite 200

Washington, D.C. 20036

Tel.: (202) 331-2472

E-mail: info@group30.org, www.group30.org



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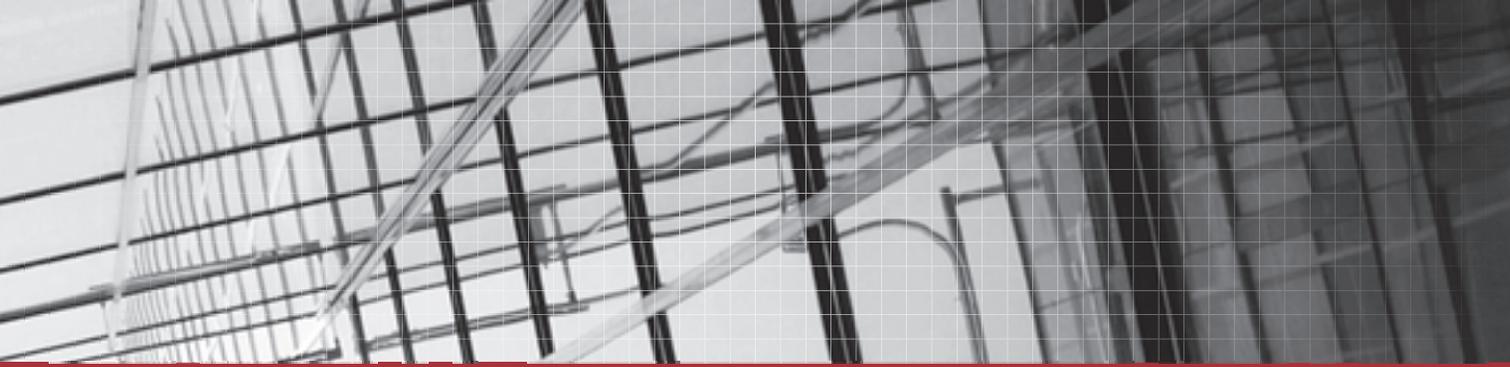
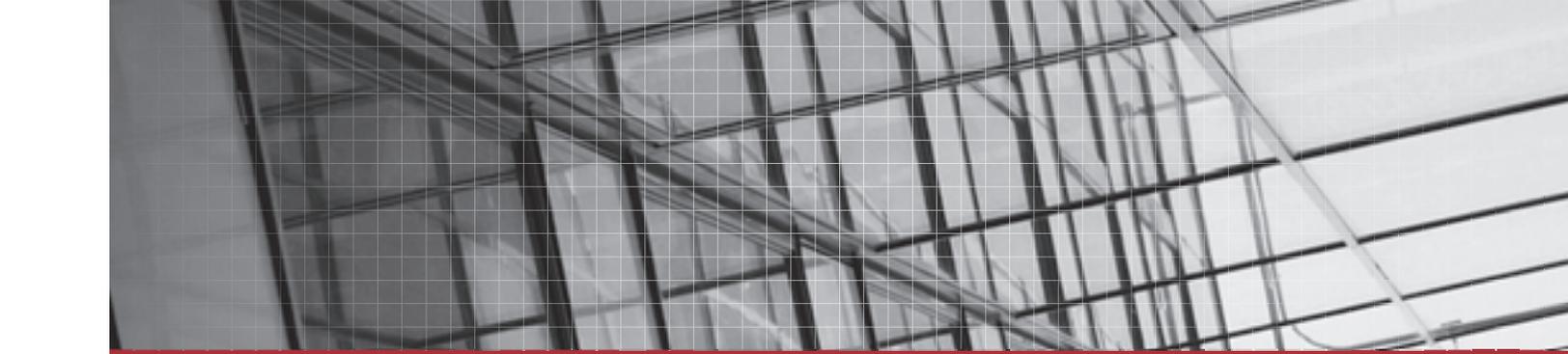


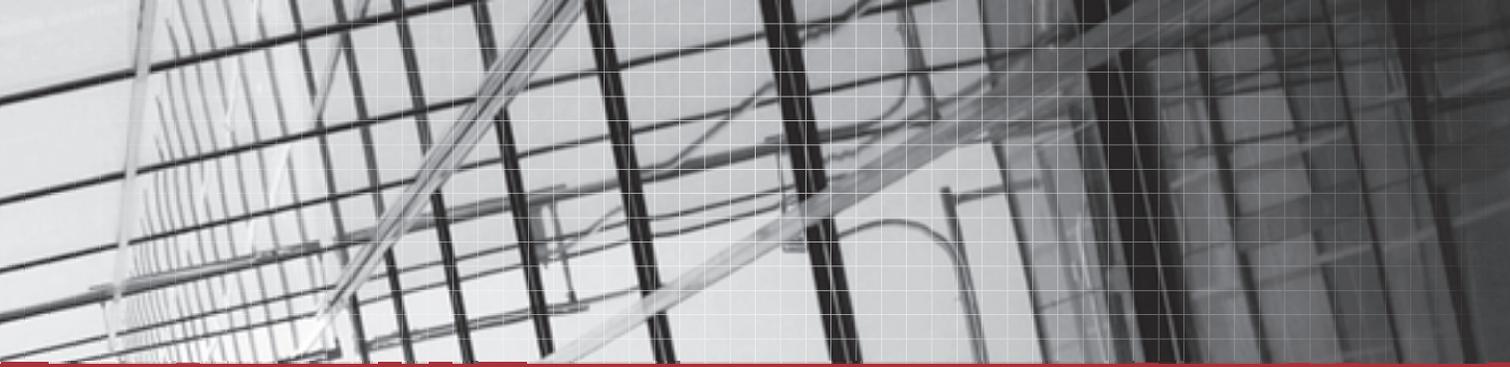
TABLE OF CONTENTS

Abbreviations	4
Foreword	5
Acknowledgements	7
List of Working Group Members	9
Themes and Executive Summary.....	11
Recommendations.....	17
Chapter 1: What the New Paradigm of Board-Supervisor Relations Should Look Like	21
Chapter 2: What Supervision Should Contribute	25
Chapter 3: What Boards Should Contribute	33
Chapter 4: Culture and Ethical Standards.....	37
Appendix 1: What Others Have Said About Supervisory-Board Relations	43
Appendix 2: An Illustrative Template for Assessing Board Effectiveness	47
Bibliography.....	51
Group of Thirty Members 2013	53
Group of Thirty Publications	57
BOXES	
Box 1: Supervision and Regulation are Different, and High-Quality Supervision Matters to Financial Stability	15
Box 2: The Role of the Home Supervisor	36



ABBREVIATIONS

CEO	chief executive officer
CRO	chief risk officer
FI	financial institution
FSB	Financial Stability Board
G30	Group of Thirty
IMF	International Monetary Fund
SIFI	systemically important financial institution
SSG	Senior Supervisors Group



FOREWORD

In 2012, the Group of Thirty (G30) published *Toward Effective Governance of Financial Institutions*, which showed how weak and ineffective governance in systemically important financial institutions (SIFIs) contributed to what the report called “the massive failure of financial sector decision making that led to the global financial crisis” (p. 5). In reaction to that report, the supervisory and Financial Stability Board community urged the G30 to provide additional insights into how interactions between boards and supervisors could be enhanced, and how the issue of strengthening and assessing risk culture could be tackled, particularly for SIFIs. This publication provides that information.

This report finds that it is time to create a new paradigm for interaction between supervisors and boards of major financial institutions across the globe. There are many areas of interest common to both, and systematic improvement is essential to the more effective operation of both supervisors and boards. Mutual respect and trust, and surprise-free relations, are needed not only during times of stress. Rather, a long-term investment must be made to maximize relations between supervisors and boards so they are better able to fulfill their responsibilities no matter what challenges arise.

This is a requisite and worthwhile goal. It is important that boards and supervisors interact in areas such as assessment of strategies and risks, governance effectiveness, and consideration of “culture.” This does not reduce, and should respect, the importance of management’s regular and frequent interaction with supervisors.

Research conducted for this report confirmed that current relations between boards and supervisors generally are not optimum. However, some supervisors and some banks have started to implement the new paradigm recommended in this report. Supervisors need to know that boards are doing an effective job and to act appropriately if they are not. Boards can benefit greatly from the insights supervisors have about the institution itself and compared to its peers. When difficult issues must be addressed at an individual financial institution, or in times of financial system stress, solid supervisory-board relations can help immensely in achieving an expeditious solution.

Realism is important. The goal is not a partnership. The fact that it is the responsibility of supervisors to assess boards means there will inevitably be occasional tension, and the new paradigm requires a substantial increased time commitment from many board members and supervisors. But the potential payoff is large. What is needed is not more of the same, rather it is a step change in the level and quality of the interaction between boards and supervisors, and having the right people who take the time to make that happen.

Supervisors have rightly increased their expectation of boards. This is important to forward-looking supervision. Boards need to be able to engage with supervisors who understand how boards work, in a trust-based way, to clarify expectations, seek guidance, discuss issues that arise, and demonstrate their effectiveness.

Everyone involved must understand the essential role that judgment-based supervision, as opposed to regulation or rule setting, plays in financial stability.

Supervision needs to be accorded adequate stature in countries and in international deliberations. It also often needs to have better resources—both monetary and in terms of quality of personnel—to be able to effectively engage senior management and boards. And it needs to be independent from political influence in matters of safety and soundness. Yet, many official studies continue to identify adequacy of resources, both monetary and personnel, and independence of supervisors, as significant issues. This is unacceptable; high-quality supervision is a lot less expensive than a financial crisis.

Many boards of SIFIs can do more, as well. They need to be proactive and take supervisory relations seriously and demonstrate that they understand its importance. They need to be open to supervisors so supervisors can do their job. More boards need to focus on risk culture. Boards, too, need to have adequate personnel resources, with the right skills and time commitment to deal effectively with supervisors. Even if viewpoints on the issues differ, boards need to have the attitude that an effective supervisor with adequate experience, judgment, and seniority can provide value that enhances the board's effectiveness.

This report explains how the new paradigm can be built. It includes ideas on how supervisors and boards can best assess board effectiveness and risk culture.

* * *

This project was launched in early 2013, led by the same Steering Committee responsible for the

Effective Governance report—Roger W. Ferguson, Jr. as chair; and John G. Heimann, William R. Rhodes, and David Walker as vice-chairmen. They were supported by ten other G30 members. Some sixty interviews—done under the Chatham House Rule to encourage candor—were conducted with senior supervisors and board members of many of the largest, most complex global and domestic banks in fifteen countries. Views were elicited about the current state of supervisory-board relations, the value of high-quality interaction to both, and how such interaction could be promoted.

The report, which is the responsibility of the G30 Steering Committee and Working Group, reflects broad areas of agreement among the participating G30 members, who took part in their individual capacities. All participating G30 members have had the opportunity to review and discuss preliminary drafts. Members participated in their personal capacities and did not represent their individual public or private sector institutions.

While the focus of the report is on SIFIs, and mostly on banks, the observations and recommendations have wider application. Recognizing that there are differences in board structure across jurisdictions, the approach recommended here is applicable to both unitary and dual boards (that is, a structure with a management board and a supervisory board).

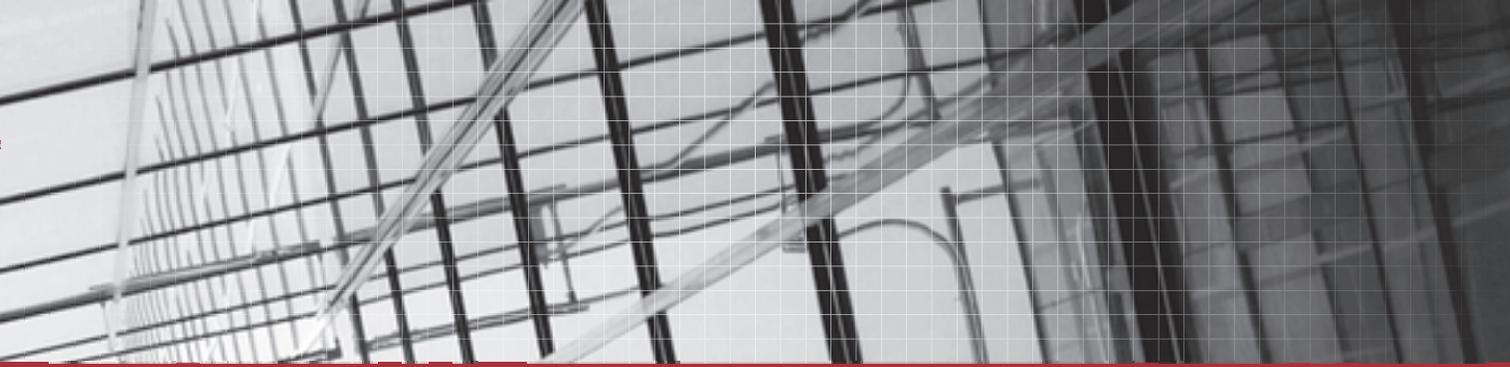
The report continues the long G30 tradition of publishing timely, critical studies of interest to the financial community. We hope it will prove useful to both individual supervisors and board members, as they strive to increase their effectiveness in support of safe, sound, and successful financial institutions.



Jacob A. Frenkel
Chairman of the Trustees
Group of Thirty



Jean-Claude Trichet
Chairman
Group of Thirty



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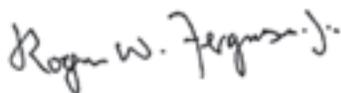
On behalf of the entire Group of Thirty (G30), we would like to express our appreciation to those whose time, talent, and energy have driven this project to a rapid and successful completion.

We would like to thank the members of the Steering Committee and Working Group, who guided our work at every stage and added their unique insight. The intellect and experience brought to the table by the ten members of the Working Group on this important subject were remarkable and essential to its success.

No project of this magnitude can be accomplished without the committed effort of a strong team. The G30 extends its deep appreciation to Project Director Nick Le Pan and the project team—James Wiener, Davide Taliente, and Dominik

Treec, of the consulting firm, Oliver Wyman—for their contribution to the analysis and conclusions of the report, based on their experience. The project team designed and conducted the core interviews, synthesized insights and conclusions from the interviews and from other research, and prepared analyses and texts for review by the G30 Working Group members.

Finally, the coordination of this project and many aspects of project management, Working Group logistics, and report production were centered at the G30 offices in Washington, D.C. This project could not have been completed without the efforts of Executive Director Stuart Mackintosh and his team, including Meg Doherty and Corinne Tomasi of the G30.



Roger W. Ferguson

Chairman, Working Group on Banking Supervision



John G. Heimann

Vice-Chair



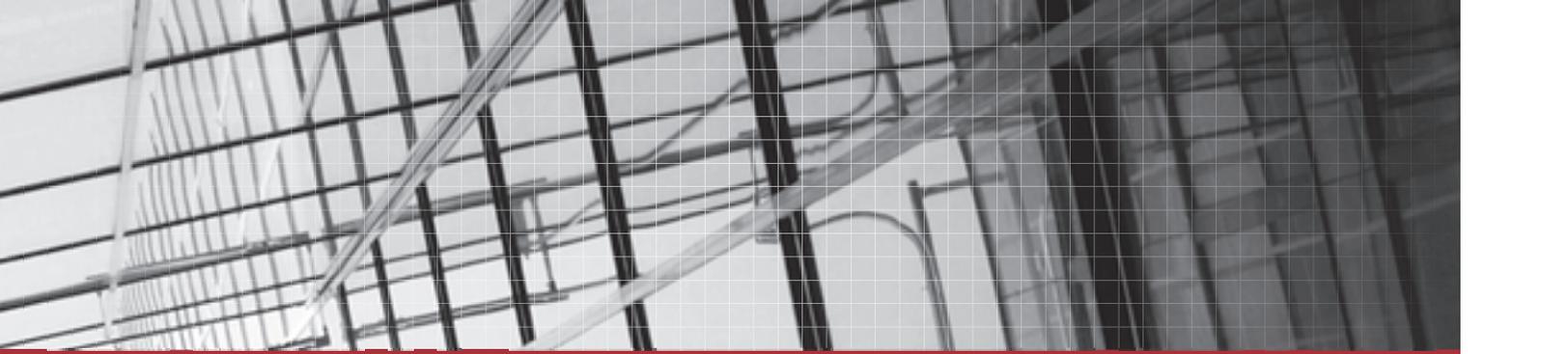
William R. Rhodes

Vice-Chair



David Walker

Vice-Chair



LIST OF WORKING GROUP MEMBERS

STEERING COMMITTEE

CHAIRMAN

Roger W. Ferguson, Jr.

President & CEO, TIAA-CREF

Former Vice Chairman, Board of Governor of the Federal Reserve System

VICE CHAIRMEN

John G. Heimann

Founding Chairman, Financial Stability Institute

Former US Comptroller of the Currency

Former Superintendent of Banks, New York State

William R. Rhodes

President & CEO, William R. Rhodes Global Advisors, LLC

Senior Advisor, Citigroup, Inc.

David Walker

Chairman, Barclays PLC

Former Chairman, Morgan Stanley International, Inc.

PROJECT DIRECTOR

Nick Le Pan

Former Superintendent of Financial Institutions for Canada,

Office of the Superintendent of Financial Institutions

WORKING GROUP

Jacob A. Frenkel

Chairman of the Board of Trustees,
The Group of Thirty
Chairman, JPMorgan Chase International
Former Governor, Bank of Israel

Jean-Claude Trichet

Chairman, The Group of Thirty
Honorary Governor, Banque de France
Former President, European Central Bank

Geoffrey L. Bell

Executive Secretary, The Group of Thirty
President, Geoffrey Bell and Company, Inc.

Richard A. Debs

Advisory Director, Morgan Stanley
Former President, Morgan Stanley International
Former Chief Operating Officer, Federal
Reserve Bank of New York

Guillermo de la Dehesa

Vice Chairman and Member of the Executive
Committee, Grupo Santander
Chairman, Aviva Grupo Corporativo

Gerd Häusler

Chief Executive Officer, Bayerische Landesbank
Former Managing Director & Vice Chairman,
Lazard & Co.

Philipp Hildebrand

Vice Chairman, BlackRock

William J. McDonough

Former President, Federal Reserve
Bank of New York

Guillermo Ortiz

President and Chairman, Grupo
Financiero Banorte
Former Governor, Banco de México

Axel A. Weber

Chairman, UBS
Former President, Deutsche Bundesbank

EXPERTS

Davide Taliente, Oliver Wyman

Dominik Treeck, Oliver Wyman

James Wiener, Oliver Wyman

Stuart P.M. Mackintosh, The Group of Thirty

THEMES AND EXECUTIVE SUMMARY

Research for this report identified the need for a new paradigm of interaction between supervisors (as the guardians of financial stability) of major systemically important financial institutions (SIFIs) and the boards of those financial institutions (FIs) (as designated fiduciaries and overseers of the institution). Since the financial crisis, much attention has been on new regulations in areas such as risk-based capital, liquidity, resolution, and risk management. Not enough attention has been placed on “softer” issues that rules alone cannot address, such as enhancing supervisor-board relations to improve supervisor and board effectiveness, or on the culture of firms, which many observers consider to be contributors to the financial crisis. Supervision is different from regulation, but, like regulation, high-quality supervision matters to financial stability. The interaction between boards and supervisors should be ongoing and, when effective, should render serious problems or crises much less likely.

The new paradigm recognizes the many shared interests of boards and supervisors, and is one of

trust, openness, and avoidance of surprises. It does not supplant, and should respect, the essential and regular interaction between supervisors and the management of major firms. This will be a material change, requiring major investments of time and relationship building by many. Some supervisors and some banks have started to implement the new paradigm recommended in this report, and are finding it beneficial. Others, who are at earlier stages, expressed an almost unanimous desire to move in this direction. Yet others, such as those in Europe, are reengineering their supervisory approach for major banks and may find the new paradigm useful.

The new paradigm recognizes the many shared interests of boards and supervisors.

The report builds on the recommendations of many other reviews¹ that: reaffirmed the primacy of the board for the implementation of effective corporate governance; emphasized the importance of the leadership role of the chairman in setting key board priorities; and specified key enablers in terms of adequate board skill sets, regular board effectiveness reviews, and good visibility on risk/prudential matters for the board. These factors

¹ See Appendix 1.

are critical in board interaction with supervisors. Supervisors need to be able to verify the effectiveness of corporate governance, understand strategies and risks in FI business models, and engage in dialogue on risk culture to identify potentially serious problems. Board-supervisor interaction can also help boards be more effective by providing the unique insight of supervisors on the FI itself and relative to its peers, and on market developments.

Four actions are needed to make this happen:

1. Boards and supervisors should adopt a paradigm of trust-based interaction based on clear mutual expectations, with a focus on examining business model vulnerabilities, governance effectiveness, and culture. The goal is effective two-way communication, predictability, and no surprises from either party.

This requires proactive, formal and informal, regular interaction. The dialogue between supervisors and boards must be two-way, and matters under consideration or areas of potential concern that are discussed in confidence must be kept confidential. Private discussions that are used against the organization, or public disclosure of confidential communications, undercut the supervisory process and erode trust. By dealing directly with boards, supervisors reinforce the role of the board and assist in achieving better outcomes for both. In contrast, by neglecting involvement of the board in supervisory communication, supervisors can undercut the board's authority and stature.

If structured along the lines recommended in this report, supervisors and boards can derive significant value from interacting concerning the following three areas:

- ◆ **Assessment of strategies, business model, and risk vulnerabilities:** Boards are increasingly focusing on helping to shape strategy, and on

understanding how strategic decisions and risk appetite affect the firm's sustainability, prudential standing, and ability to recover in a crisis. Robust discussions of these issues bring significant benefits to board members in understanding the bank and discharging their responsibilities. Within a dual board structure, these are key responsibilities of the supervisory board.² They are also areas where supervisors can bring unique perspectives derived from their experience and analysis of peer situations and emerging trends within financial markets.

- ◆ **Assessment of governance effectiveness:** Our research indicates that an approach based on structured interviews and discussion between supervisors and board members, using examples of different corporate governance practices, is the best way to assess effectiveness. That includes discussions with the chair, chairs of key committees, and others about how they view their effectiveness, the behavioral dynamic of the whole board process, how they challenge and guide management, how they shape agendas, how they use information provided to them, and how they know that risk appetite statements are being applied appropriately. Supervisors must focus on the demonstration of effective behaviors, not just on structural matters such as board composition and mandate. These assessments should focus on identifying potential serious problems and addressing them, and providing constructive feedback to others, rather than simply checking the compliance of various boards. The report provides an illustrative template for this approach.
- ◆ **Assessment of FI culture:** Boards must understand the risk culture of their organization in conjunction with their business model, and not take it for granted. Supervisors must recognize that no one culture is "right" for a

² This is different from the structure that exists in some countries, with a board of directors including non-executives who have these responsibilities, and a board of supervisors whose role is to ensure that the board is operating appropriately (where it is important to ensure that the roles are not blurred). In this report, "supervision" means the responsibility exercised by the authorities, not by the board of supervisors.

major FI, and should avoid a detailed prescriptive approach. Their realistic expectation should be to identify culture and its implications, and at a minimum ensure that FIs deal with unchecked extremes that could lead to serious problems. The report suggests a taxonomy to assist supervisor-board discussions regarding culture, and urges recognition that these require a range of soft judgments. Compensation systems and hiring and promotion decisions must support the desired risk culture.

Macroprudential regulation can pose challenges to building effective supervisor-board relations. Macro authorities can provide material benefits to boards if they share insights with boards about risk buildup and risk aggregation. To avoid surprises, effective coordination of action and communication is key between macro authorities and supervisors interacting with boards, since both deal with capital and liquidity issues that greatly impact board-level decisions.

2. Boards and chairs need to recognize that supervisory interaction takes time and good preparation, and they must shift to a proactive mindset. Leadership by the board chair and chairs of key committees is essential for board effectiveness and productive supervisory relations.

Some boards have designated board members to have a role in supervisory relations, and these board members make it their business to be proactive and initiate contacts. All major FIs should welcome interaction with supervisors, even if viewpoints on the issues differ, and recognize the potential added value of supervisors with relevant experience and seniority. The boards should be open to explaining how they discharge their responsibilities so supervisors can obtain the information needed to do their job. Chairs need to set the tone and lead by example.

FIs should welcome interaction with supervisors, even if viewpoints on the issues differ.

Boards should have skill sets (risk, industry, and other experience) and take the time to deal effectively with supervisors. Boards need to understand supervisory approaches, expectations, and issues (in addition to new regulation), and effectively use resources in management risk and control functions, and outside assistance to the board or its committees. Boards also need to satisfy themselves that management's relations with supervisors are effective, and that compliance issues and supervisory findings are treated seriously.

3. Supervisors should be clearer about their objectives, and knowledgeable about sound governance practices in areas of greatest value to engagement with boards.

Better clarity about and understanding of the respective responsibilities of supervisors and boards will help ensure that supervisors do not expect boards to perform management's role. Clarity about responsibilities would also help supervisors communicate with boards about the issues that need board attention and action. This will help boards understand what to expect from supervisors in such areas as peer assessment, where supervisors are uniquely placed to assist boards in performing their challenge role. It should be recognized that effective board challenge occurs in many ways. Boards need to recognize that supervisors are a valuable resource in providing useful insights into the institution and the quality and effectiveness of its management and control systems.

Some supervisors have drafted written expectations of boards that specify both the behaviors expected and the desired characteristics of members. This should be general practice. Some supervisors have met periodically with board members and supervisors of major institutions to discuss expectations, how boards are operating, and other relevant matters. These were clearly welcomed by boards. The G30 supports this approach.

The G30 recommends that supervisors create centers of expertise in business model analysis and governance to assist supervisory teams. These teams should develop the analytical capabilities to rigorously analyze market practices and trends to provide supervisors with additional insight for boards. Supervisors should compile the views of off-site teams (if relevant) and of macroprudential authorities to enrich the information they can provide to boards.

Consistency in supervisory treatment is essential, as is the sharing of good practice across major FIs. Within countries, that requires sharing analysis, assessments, and interventions across supervisory teams. Internationally, the G30 encourages the Senior Supervisors Group (SSG)³ to regularly share supervisory experiences in interaction with boards and in judging board effectiveness. The SSG should periodically publish best practice information to assist boards and other supervisors.

4. National governments must recognize the need for stature and adequate resourcing and staffing for prudential supervisors.

Supervision is different from regulation or rule setting, and governments need to better understand the essential role that supervision, as opposed to regulation or rule setting (see box 1), plays in financial stability. Supervision is much more than checking compliance with rules and regulations; it deals with behaviors, which regulation often cannot. It involves making judgments about the risks inherent in institutions, about the quality of their management and governance systems, and about intervening, if necessary.

Greater stature of supervision increases its credibility.

Greater stature of supervision increases its credibility, and contributes to its effective engagement with global banking organizations at the most senior levels and to the ability to attract and retain staff. Stature comes from public recognition by governments, the demonstrated importance placed on supervision within the national authorities, independence in prudential matters, and the provision of sufficient resources, both personnel and financial.

Supervisors need to be empowered with upgraded skills, increased experience, greater analytical support, and greater stature to effectively engage boards. In many countries, supervision is paid for by the industry supervised. In fact, many in the financial industry say they are prepared to pay more for high-quality supervision. The International Monetary Fund (IMF) and the Financial Stability

Board (FSB) need to find a better way to ensure that material deficiencies they regularly identify in their reviews of supervisory independence and resourcing are followed up and rectified.

It was the view of many people interviewed for this report that international and domestic standard setters need to do a better job ensuring that the supervisory implications of new regulatory initiatives are understood and taken into account in policy making, and that resources to adequately implement those initiatives are provided. The G30 agrees.

Recommendations are summarized below. The following chapters detail the new paradigm proposed by the G30, and the contribution that supervisors and boards should make. A final chapter considers how both boards and supervisors can better assess risk culture.

³ The SSG is a forum for senior representatives to engage in dialogue on risk management practices, governance, and other issues concerning complex, globally active institutions. It is currently chaired by the Federal Reserve Bank of New York.

BOX 1: SUPERVISION AND REGULATION ARE DIFFERENT, AND HIGH-QUALITY SUPERVISION MATTERS TO FINANCIAL STABILITY

Supervision is assessing inherent risk in financial institutions and whether appropriate corporate governance, management capability, and operational processes are in place at the board and senior-executive level to oversee, understand, measure, and manage that risk. Supervision includes early intervention by the supervisor to have the institution rectify deficiencies, and choosing appropriately from a variety of informal and formal tools to be effective and to avoid unnecessary costs. High-quality, timely supervision makes institutions more resilient. It reduces the likelihood and severity of material financial or operational problems, thus enhancing financial stability.

Supervision is not regulation, which is the setting of rules that apply to the institution. And supervision is much more than assessing

compliance with rules, although compliance is essential. Rather, supervision deals with behaviors that rules cannot.

Supervision requires qualitative monitoring and assessing of the capability and behavior at the board and senior-executive level. It requires considerable judgment on the part of the supervisor, and deep knowledge about the institution.

Supervision is not running the institution, and supervisors must rely on governance, risk management, and control processes of the institution while testing to confirm whether reliance is well placed.

Supervision cares whether financial institutions are successful—which is the best assurance of their safety and soundness. Supervision is not designed to prevent all losses or failures.



RECOMMENDATIONS

WHAT THE NEW PARADIGM OF BOARD-SUPERVISOR RELATIONS SHOULD LOOK LIKE

To enhance their effectiveness, boards and supervisors of major FIs must make a long-term commitment to building and sustaining closer, trust-based relations founded on open communication. This requires use of formal and informal channels between senior supervisors, the whole board, the chair, and the chairs of key committees. The discussion needs to respect private conversations, cover the right topics, and avoid surprises. The interaction must be two-way, with supervisors contributing their views and suggestions on issues they think board members should consider.

- 1.** Both parties should adopt the principle of no avoidable surprises.
- 2.** Boards and supervisors need to devote time and effort to their interactions, even when there are no particular stresses, and meet regularly.
- 3.** Except during periods of significant stress, the subjects for communication should not be dominated by the most recent supervisory findings, or the most recent stress test exercise, or what challenge occurred at the most recent board or committee meeting.

- 4.** Boards and supervisors need to understand and respect each other's duties, powers, responsibilities, and authority.

WHAT SUPERVISION SHOULD CONTRIBUTE

Many governments need to elevate the stature of supervision within the part of the public sector responsible for financial stability. Governments should periodically publicly reaffirm the importance of supervision to financial stability, and ensure that supervisory agencies have high-quality leaders who understand and prioritize supervision and that the supervisory bodies are fully independent in prudential matters and better resourced to deal with new challenges, including dealing effectively with governance issues. Supervisory bodies need to prioritize supporting and assessing board effectiveness and take specific action to help build the new supervisor-board paradigm.

- 1.** Authorities should upgrade supervisory talent.
- 2.** Supervisors should make dealing with boards a priority.
- 3.** Supervisors must be sure that the people interacting with boards are sufficiently senior,

knowledgeable, aware of overall supervisory (and regulatory) direction, and empowered to express views, exercise judgment, and provide advice.

4. Supervisors should clearly state their expectations regarding supervisory-board relations, and should publish guidance and ensure that the guidance promotes and supports the kind of interaction specified in this report, with a particular focus on the behaviors supervisors expect from board members, including what supervisors mean by effective challenge.

5. Supervisors should share their insights on larger governance trends with boards.

6. Policy-making bodies should involve supervisors in their regulatory decision-making processes.

7. The periodic supervisory assessment of the effectiveness of boards of SIFIs is a legitimate and important part of the supervisory process, provided supervisors invest in the tools and people development to do it well. Supervisory assessments of boards can contribute to the continual improvement of boards, and can deal with outliers, where weak or ineffective governance might prove to be a source of major systemic problems.

8. For consistency across major institutions in board-level matters, and to promote improvement, supervisors need a robust internal quality assurance process and a better internationally consistent process, and need to actively seek feedback on their performance from industry, including from board members.

9. Policy makers need to strengthen and focus IMF and FSB supervisory assessments.

WHAT BOARDS SHOULD CONTRIBUTE

Boards of financial institutions need to welcome interaction with high-quality supervisors, view that interaction as contributing to board effectiveness, and understand that it is the responsibility of the supervisor to seek reasonable assurance that the board is effective and the institution's risk culture is appropriate and to help the supervisors fulfill that responsibility. Boards need to make enhancing supervisory relations a priority and take specific action to support the new paradigm recommended in this report.

1. Boards of SIFIs must have members who have ongoing relationships with supervisors and who are versed in matters of interest to the supervisor.

2. Boards need to understand how their structure helps or hinders relations with supervisors.

3. Boards should oversee management's relations with supervisors, and ensure that senior management includes people who are able to foster high-quality relations with supervisors, and that one of the CEO's direct reports has overall responsibility for group-wide supervisory relations with the FI's main regulators.

4. Boards need to devote sufficient time to understanding supervisory, as opposed to regulatory, methodologies and priorities.

5. Boards need to focus on their own effectiveness, and that self-assessment should be grounded in an understanding and demonstration of effective board behaviors. Boards should be continuously seeking to improve their corporate governance practices.

6. Boards should be proactive in engaging supervisors in formal discussions about board effectiveness.

CULTURE AND ETHICAL STANDARDS

Boards must understand the culture of their organization, in conjunction with their business model. While an institution's broader culture affects its attitude toward risk taking, it is important to prioritize attention to risk culture since it has the most direct connection to safety and soundness of financial institutions. Boards should identify and deal seriously with risky culture, ensure their compensation system supports the desired culture, discuss culture at the board level and with supervisors, and periodically use a variety of formal and informal techniques to monitor risk culture. Supervisors should share their observations about the institution's risk culture with the board, and should watch for serious culture issues that need rectification. Supervisors and policy makers should be cautious about writing rules or guidance about culture, and should set realistic expectations about what is achievable.

- 1.** Supervisors and boards should use a short list of simple descriptors of culture, both “good” and “bad.” Using this kind of taxonomy helps boards identify their own FI’s unique culture, better understand its benefits and risks, and assess whether mitigants are in place. Boards (and supervisors) should not take it for granted that they know what the culture of the institution is or that desired behaviors are well understood by staff.
- 2.** Boards and supervisors should understand that assessing culture is about assessing people, individually and collectively, using so-called “soft” skills (that is, effective leadership and values). Independent board members are uniquely placed to judge culture because of their senior-level experience in other businesses and other walks of life that they bring to the organization. Supervisors can also assess risk culture if they have the right skills, communication ability, and approach.
- 3.** Boards should determine whether compensation structures and key personnel decisions support the desired culture. Supervisors and boards should discuss how the link between compensation and desired behavior is working.

WHAT THE NEW PARADIGM OF BOARD-SUPERVISOR RELATIONS SHOULD LOOK LIKE

To enhance their effectiveness, boards and supervisors of major financial institutions (FIs) must make a long-term commitment to building and sustaining closer, trust-based relations founded on open communication. This requires use of formal and informal channels between senior supervisors, the whole board, the chair, and the chairs of key committees. The discussion needs to respect private conversations, cover the right topics, and avoid surprises. The interaction must be two-way, with supervisors contributing their views and suggestions on issues they think board members should consider.

RECOGNIZING AREAS OF MUTUAL INTEREST

In the wake of the financial crisis, significant challenges exist in building these relations. Trust in governance has been eroded. The supervisory mindset is understandably more intensive and intrusive, but sometimes overly so. Sometimes industry has been overly resistant to necessary

change. Macroprudential regulation can complicate relations if it is at cross-purposes with supervisory priorities. The political and policy environment in many jurisdictions can make it difficult for supervisors and institutions to consider cooperative relations. Sometimes institutions are reluctant to express legitimate suggestions about

supervisory approaches, and sometimes such pushback is seen as “not getting it.” These challenges must be overcome.

Many people interviewed for this report emphasized the considerable alignment between boards and supervisors, albeit with different emphasis. Both supervisors and boards want a safe and sound institution. Both want the institution to be profitable—that is the first line of defense in ensuring safety and soundness. Both are relying on risk management and control functions working effectively, and both want to be able to confirm that reliance. Boards rightly care about shareholder interests. While protecting shareholders is not in the mandate of supervisors, they also need to care about how shareholders are treated, since that is where the capital comes from to support FIs.

Both boards and supervisors want to ensure that the board has the right skill sets to do the job.

Recognizing areas of mutual interest and structuring relations to be effective does not undercut either party’s responsibility, authority, or independence.

Supervisor-board communication needs to respect the relations that each has with management of the FI. Supervisors, boards, and management have a triangular relationship. Board communication and dialogue with senior supervisors should reinforce messages communicated to management. An important benefit for supervisors is that, by communicating with both boards and management, they can be aware of board influence on key decisions described to them by management.

WHAT TRUST-BASED RELATIONS ENTAIL

Often, the most effective board-supervisor communications will be about sensitive matters of risk management, effectiveness of key processes and people, major strategic decisions that are under consideration, culture issues, and succession.

Neither side may have yet reached firm conclusions, and soft judgments are involved.

Building and sustaining effective relations in “good” times helps both parties when they are confronted with difficult issues. While some communications will be formal, important ones will be informal. Informal discussions may involve governance issues not yet resolved by the FI. This is effective governance in action; board members must trust that supervisors will not take what is said in these informal meetings and use it against directors or the organization.

Supervisors need to express observations on sensitive topics like the organization’s culture or weaknesses they observe in risk management personnel, and trust these will not be automatically reported back by board members in ways that undermine the supervisory process. Supervisors also have to deal with management on these matters.

Boards need to trust that any supervisory intervention that affects governance is evenhanded across major institutions. That requires supervisors to have effective internal consistency checks. Boards need to trust that supervisors genuinely want to support effective governance and will not act to undercut it, provided it is functioning effectively. That means supervisors using the board to achieve supervisory aims in areas that are directly under board purview (not by just adding things that the board is supposed to discuss or approve, as can be an issue in some jurisdictions). Supervisors need to trust that board members genuinely want to hear from supervisors and value their input.

Boards need to trust that supervisors genuinely want to support effective governance.

HAVING THE RIGHT PROCESS AND DISCUSSING THE RIGHT THINGS

A number of attributes contribute to effective, useful interactions. These include:

1. Both parties should adopt the principle of no avoidable surprises.

This requires consistency and predictability in supervisory expectations and in the board-level approach to risk and strategy. When either is changing or is expected to change, avoidance of surprises means proactive communication and understanding that large, complex banking organizations cannot “turn on a dime.” Supervisors must have the prerogative to act swiftly. But such situations should be rare rather than the norm, if the desired mutual trust and respect between supervisor and board is to be achieved.

2. Boards and supervisors need to devote time and effort to their interactions, when there are no particular stresses, and meet regularly.

A number of board members and supervisors noted that quarterly meetings among the supervisor, the chair, and chairs of key committees were a useful norm. In dual board structures where supervisory boards may be large, involving committees such as audit and risk can be particularly important. As one director said, “the goal is a frank and open discussion in private.” As one supervisor said, “this can be done while retaining professional independence and professional distance.” The goal is a dialogue rather than a one-way list of demands for information.

A mix of formal and informal communication is key, as is a mix of written and face-to-face communication. Board members need to see major written communication to the FI, (not just management’s summary), where that is not already the norm. When there are formal meetings, such as in presenting annual year-end supervisory assessments, supervisors should have in-camera time with non-executive directors.

One-on-one meetings offer an opportunity for highly productive interaction, especially between supervisors and the chair of the board or senior independent director, and chairs of key committees such as audit, risk management, and compensation.

A mix of formal and informal communication is key.

While legislation may mandate it, the regular presence of supervisors as observers at board meetings is not the best way to conduct relations. Such presence risks changing board behavior and blurring the lines of accountability.

3. Except during periods of significant stress, the subjects for communication should not be dominated by the most recent supervisory findings, or the most recent stress test exercise, or what challenge occurred at the most recent board or committee meeting.

Priority should be given to forward-looking, medium-term matters of strategic risk or direction issues and concerns, progress toward goals, significant general concerns, or areas that either board members want reaction to or that supervisors want to ensure boards are aware of and focused on.

To the extent that supervisors have current issues, board members benefit from discussion not just of those issues, but also of root causes. That type of discussion helps boards be most effective in overseeing the FI, and supports how boards operate. It also allows supervisors to harness the power of the board in driving change.

In human resources matters, the focus should be on how the compensation and talent management system is providing incentives to support the desired risk appetite and risk culture. Succession planning for the board, CEO, and senior executives should also be discussed.

4. Boards and supervisors need to understand and respect each other’s duties, powers, responsibilities, and authority.

Having good relations does not mean that supervisors will not have to deliver tough messages and use their powers to encourage or, if necessary, force, change. Nor does having good relations mean that boards will never push back when they think the supervisor has it wrong, or where they feel the supervisor

is asking the board to perform management's role. The new paradigm means that supervisors can specify objectives they want achieved and have productive input with boards (and management) about how to achieve them.

ADVANCE ASSESSMENT OF BOARD MEMBERS

Many jurisdictions now have formalized assessments of individual board members in advance of appointment. The approaches vary from “fit and proper” interviews for all new directors to notification requirements prior to appointment, but minimal vetting for suitability, relying more on the board nomination process. There is, of course, no substitute for ongoing assessment of board effectiveness, which all supervisors should be doing. No one process is clearly superior, and each has risks. Formal vetting is difficult to do effectively without adequate supervisory experience. It may reduce the responsibility of the board in finding good candidates, and can make it harder for the supervisor to act subsequently. A system with no possibility of formal vetting misses an important opportunity to identify candidates whose track record of oversight and risk awareness is clearly not up to the task of governance of a complex SIFI.

A considerable number of supervisors and board members interviewed for this project thought that, on balance, some form of pre-vetting was appropriate. To work effectively requires supervisory expertise, assessment tools that are relevant to board functions, and board members being open to the process.

By far, the most important aspects of advance assessments are that they sensitize financial institutions to the importance of vetting the qualifications and capabilities of board appointees, they sensitize supervisors to the importance of understanding board structure and member competencies, and

they further reinforce the prerogatives of supervisors in taking actions with respect to the board in extreme circumstances.

DEALING WITH MACROPRUDENTIAL AND MICROPRUDENTIAL MATTERS

Macroprudential regulation is a significant new focus for regulators and supervisors and for central banks. It can create conflicts between microprudential supervision and systemic considerations, which are well recognized. In countries with relatively few large banks, macroprudential policies on capital or liquidity can overlap with supervision approaches for individual major institutions. These issues have board-level implications. However, macroprudential assessments and decisions may be performed by people who are not connected with the supervisory process (with whom the boards interact). That means opportunities for boards to gain useful insights and to provide their perspective either do not occur or are difficult to create.

Macroprudential analysis, including overall market insights, can be extremely useful to boards, as can the views of macro authorities on the buildup of new risks and the possible impact of herding behavior with interconnected markets.

Macroprudential authorities may have rule-setting powers and, at a minimum, can often issue direction to supervisory authorities. They need to make sure that their communications and actions are well coordinated with the communications of supervisory authorities and with boards. Public communication should be structured so it is not unintentionally construed as comment on individual FI positions.

While both supervisors and boards must contribute to the new paradigm of interaction, there are particular aspects that are more in the domain of one or the other. These are explored in the next two chapters.

Having good relations does not mean that supervisors will not have to deliver tough messages.

WHAT SUPERVISION SHOULD CONTRIBUTE

Many governments need to elevate the stature of supervision within the part of the public sector responsible for financial stability. Governments should periodically publicly reaffirm the importance of supervision to financial stability, and ensure that supervisory agencies have high-quality leaders who understand and prioritize supervision, and that the supervisory bodies are fully independent in prudential matters and better resourced to deal with new challenges, including dealing effectively with governance issues. Supervisory bodies need to prioritize supporting and assessing board effectiveness and take specific action to help build the new supervisor-board paradigm.

The predominant focus of authorities, postcrisis, has been the regulatory (rules) framework. As a result, supervisory emphasis has often been on compliance with new regulation rather than on assessing the soundness of business strategies, the prudence of risk taking, governance effectiveness, and the health of institutions' culture. While work on regulation has been of the utmost necessity, now is an appropriate time to focus on the importance of supervision and invest in improving its effectiveness.

The crisis and its aftermath have created challenges for supervision. The volume and complexity of new regulation mean an unusually high workload. Implementing regulatory issues often takes priority in the supervisory process. Supervisors can be overwhelmed with simply ensuring these issues are addressed and closed.

Most importantly, supervisors need to be free to apply judgment within their regulatory and policy context. The current political environment

is highly risk averse, which can result in limitations on supervisors' ability to assess the significance of individual governance matters. This environment may on occasion make it more difficult for supervisors to acknowledge progress that individual institutions are making.

Sometimes supervision is conducted by several agencies, and the stature governments ascribe to them within the national authorities affects the kind of interactions they can have with senior decision makers, including FI boards. Where supervisory agencies are part of central banks, it is important that supervision not be viewed as of secondary importance to the development of monetary policy or to the central bank's macro role in financial stability. While rotation of supervisory team members is important for independence, that should not undermine the continuity needed to deal with boards.

Recognizing the importance of supervision and enhancing its practice require several actions.

1. Authorities should upgrade supervisory talent.

Supervisors increasingly require substantial additional "bench strength" of senior-level judgment and communication skills to allow them to build effective relations with boards and senior management and to undertake meaningful assessments of board effectiveness or risk culture.

Boards and supervisors interviewed for this report confirmed that there are many high-quality supervisors doing excellent work. They also noted a worrisome frequency of supervisors who did not have the capability to deal effectively with board-level issues. A number of supervisors discussed their approach to building talent to address new challenges, but many also commented on the incredible challenges of the new agenda, much of which directly involves the work of boards.⁴

Supervisory challenges can include lack of experience or stature to be able to effectively engage with board members, and being uncomfortable with supervisory judgment calls not tied to specific rules. Drivers of this situation can include difficulty in extracting board-level issues from technical work that feeds supervisory judgments, a preponderance of legal and audit skill sets, and supervisory methodologies that promote compliance tasks. Capabilities aside, there can be a problem of a lack of supervisory resources, given the need to deal with the considerable supervisory and regulatory challenges. Use of consultants to supplement supervisors is not a solution in dealing with board-level issues. Supervisors generally understand resource challenges and have often found ways to deal with them, at least in part. But constraints can prevent developing the robust, sustainable solutions required.

Additional focus is needed on attracting and developing senior staff with an in-depth understanding of a wide range of financial services business, risk management, cultural analysis, communication skills, and an emotional intelligence associated with strong senior business leaders. Partly, this can be developed through training and thoughtful career development. Ability to have an impact, job satisfaction, and the attraction of public service are all motivators.

But supervisors also need to design career paths and opportunities for industry hires that can complement skills and abilities that can be developed internally (in particular, the first-hand experience of industry practices). Cross-collaboration and movement within the various parts of the supervisory agency or national authorities can help. Governments must allow senior supervisors to be appropriately compensated so that, combined with nonmonetary benefits, supervisory agencies can attract and retain the requisite talent. Boards and senior management should be ready to identify

⁴ The November 2012 "Progress Report to G20 Ministers and Governors" from the FSB Supervision Intensity and Effectiveness Group (Financial Stability Board 2012) continued to emphasize these resource challenges.

experienced senior professionals, toward the end of their careers, who are interested in working with supervisors. Some have used this approach successfully, and it can avoid the potential conflict issues inherent in temporary secondments.

Additional consistent benchmarking of supervisory resources against the needed skill sets is required. Having centers of expertise on governance or business line analysis is a good practice that can assist frontline teams. The use of retired board members as advisors to assist supervisors in governance issues has been successful in some jurisdictions and deserves broader consideration.

2. Supervisors should make interaction with boards a priority.

Supervisors interacting with boards of major FIs, as outlined in this report, should be an expected part of the supervisory methodology, not an option. Interaction that helps boards be more effective and that focuses more on governance, strategy, and business plans is an element in forward-looking supervision. Supervisors promoting and assessing board effectiveness, and intervening proactively to achieve necessary improvements in FI governance practices, by itself goes a long way toward building more resilient financial institutions.

Governments should remove any legal impediments to supervisors dealing with boards of directors, including ensuring adequate powers to intervene. Supervisors should develop a periodic, structured assessment of board effectiveness, as discussed below. The focus should be the oversight of strategy, risk management, compensation, succession planning, and the quality of management. The quality of information boards receive, and whether they use it effectively, rather than its volume, should be another priority.

Several supervisors reported that they have conducted annual daylong symposiums for board members of major institutions to discuss supervisory expectations and board challenges. Board

members who attended indicated they were very useful. Attendance by supervisory staff, including supervisory team leads and senior staff, can also help promote better understanding of board practice, highlighting challenges and building relations. The G30 supports these being used more generally by all supervisors of SIFIs, appropriately tailored to the situation of each country.

The supervisory assessment of board effectiveness contains inherent conflicts with respect to development of a trust-based relationship. Supervisors must be sensitive that the regular and candid dialogue they seek to build is not undermined by the careless use of feedback and information. Boards,

too, should not overreact to supervisory findings. Supervisors must, of course, maintain the integrity of their assessment process, but they should be open and realistic about whether information can be treated as “off the record,” and about when information is likely to lead to or bolster formal findings. In these instances, supervisors should ensure ample opportunity for discussion and debate regarding the nature and implications of the issues arising in one-on-one meetings with board members.

3. Supervisors must be sure that the people interacting with boards are sufficiently senior, knowledgeable, aware of overall supervisory (and regulatory) direction, and empowered to express views, exercise judgment, and provide advice.

In addition to the senior supervisor in charge of the team, a number of organizations involve more senior people, including the head of the agency, from time to time, although that person should not be de facto the lead supervisor for the institution. This has benefits for both the supervisor and the board. Whatever the level, it is crucial that the supervisor leading the interaction has adequate stature, understanding, and experience to credibly

Additional focus is needed on attracting and developing senior staff.

deal with board-level issues. Part of that understanding is about what are reasonable expectations for non-executive directors in a given situation. Where supervisors are organized in an off-site and on-site configuration, (or have policy functions that deal with institution-specific issues), all parts of the organization must be coordinated and represented in interaction with boards.

4. Supervisors should clearly state their expectations regarding supervisory-board relations, and should publish guidance and ensure that the guidance promotes and supports the kind of interaction specified in this report, with a particular focus on the behaviors supervisors expect from board members, including what supervisors mean by effective challenge.

Several supervisors, regulators, and international bodies have issued guidance or rules on governance (and some are in the process of developing such). Normally, this covers board composition and skills, board and committee responsibilities and mandates, relations between boards and key control functions, and independence requirements, among others. Such guidance or rules generally rightfully recognizes that there can be alternate ways to achieve certain objectives. These efforts alone cannot support effective interaction between boards and supervisors.

More useful guidance includes behaviors supervisors expect from boards, including elaborating on what effective challenge means. This is important, since the G30's *Effective Governance* report indicated that these “software” aspects of how boards work can be more important than the “hardware.” Effectiveness is not helped by supervisors directing more issues to the board for approval.

Guidance needs to respect the role of the board as separate from management. For example, it should avoid the use of the words “the board ensure,” in recognition of the role of the board, which is overseeing and satisfying itself through

reasonable procedures that management is implementing board direction. “Ensure” is too high a bar to judge effectiveness and misunderstands the role of the board.

Supervisors should expect that the board has robust processes to drill down on how policies, strategies, and risk appetite are being implemented.

Supervisory expectations and guidance need to recognize that effective challenge is evidenced in many ways. Requests for more information or consideration of more options before taking decisions, informal feedback by the chair or key committee chairs to management, deciding what items will be placed on the agenda and directing what management is to cover, in-depth discussions, and in-depth review and questioning of the basis for management recommendations are all examples of powerful challenge. The number of “no’s” or challenges documented in board minutes is not a useful indicator.

In addition, challenge does not need to be exercised on most matters to be effective. Too-frequent board challenge dilutes its importance and can indicate dysfunction.

Guidance could also usefully clarify the level of detail it is reasonable for non-executive board members to be expected to know about the FI. This would not reduce their formal liability, but would reduce the drift of supervisors expecting boards to take on management’s role.

5. Supervisors should share their insights on larger governance trends with boards.

Board members report they benefit greatly from supervisors indicating where their institution stands vis-à-vis others. That is a powerful motivator for improvement, and adds to supervisors’ credibility.

It is also useful to board members to have supervisory feedback of where the institution stands relative to the marketplace (“we see you as being more/less aggressive than most in this area...”).

Effective challenge is evidenced in many ways.

These insights help boards understand what is occurring and confirm (or not) its appropriateness.

In some jurisdictions, there are enough major institutions to make useful peer assessment feasible, but, even then, understanding experience elsewhere can be beneficial. In other jurisdictions, there are few SIFIs, so comparison and benchmarking requires information about other jurisdictions. As supervisors of SIFIs engage more with boards, they should regularly share their experiences with each other and share good practice observations. That would also put supervisors in a better position to share a range of observations about practice with the board members of institutions they supervise.

The Senior Supervisors Group (SSG) appears to be the best forum to engage in this regular (at least annual) process. After a period of time, the SSG should consider publishing “range of practice” observations regarding governance effectiveness, as a way of benefiting other supervisors and board members. The SSG should also organize periodic discussion with directors of major global SIFIs, to monitor how the interaction between supervisors and boards is evolving.

6. Policy-making bodies should involve supervisors in their regulatory decision-making processes.

Supervisors have unique and valuable insight at the intersection of financial stability, financial institutions, and regulatory implementation. Therefore, policy makers both at the national level and through global bodies need to consciously incorporate senior supervisors in the policy making and prudential regulation processes.

Supervisors have unique and valuable insight at the intersection of financial stability, financial institutions, and regulatory implementation.

In particular, the G30 believes that the principal international policy-making bodies, including the Basel Committee on Banking Supervision, the Financial Stability Board, and the International Monetary Fund, do not have adequate representation of senior supervisors in their policy-making committees and initiatives. This is also true for policy making within local jurisdictions, and such bodies are strongly encouraged to increase representation from senior supervisors and consult with supervisors throughout the policy-making process.

7. The periodic supervisory assessment of the effectiveness of boards of SIFIs is a legitimate and important part of the supervisory process, provided supervisors invest in the tools and people development to do it well. Supervisory assessments of boards can contribute to the continual improvement of boards, and can deal with outliers, where weak or ineffective governance might prove to be a source of major systemic problems.

The state of the supervisory assessment of boards varies widely globally, including within the G20.⁵ Some supervisors have been doing this as part of their assessment of “management” in their rating system. Some have an explicit part of their supervisory methodology that relates to the board. Others have formal fit and proper tests on the appointment of new board members but little ongoing assessment. Some have created centers of expertise within the supervisory organization to help. A number include board oversight in supervisory reviews of particular areas of the FI.

Based on research for this report, it is clear that much of the current supervisory assessment is

⁵ This was confirmed in research for this report, and in the “Thematic Review on Risk Governance, Peer Review Report” published by the FSB in February 2013.

focused more on the characteristics of the board—size, skills, adequacy of mandate and charters, nomination process, tenure, independence, and so on. Some supervisory assessment is focused on adequacy of material going to the board. Board members report that many supervisors have increased the number of matters requiring board approval. While these are necessary considerations for supervisors, they are not sufficient.

Much less supervisory attention is focused on board effectiveness (as opposed to characteristics), even though effectiveness should be the focus. A few supervisors are making concerted efforts. The reality is that supervisors have traditionally found it easier to assess the adequacy of the boards of smaller institutions than of the larger, more complex SIFIs.

Supervisors should base assessments on a clear understanding of the oversight and stewardship role of boards, not on activities that amount to supplanting management. Assessments should be based on in-depth discussion with the board chair, the chair of the Audit Committee, the chair of the Risk Committee, and others. That, together with other supervisory work, can help supervisors understand and document examples of effective or ineffective behaviors.

Some supervisors have access to the self-assessments done by boards. This should be one input, but one input only, into supervisory assessment.

The research for this report also revealed that, based on the interaction they have and from their knowledge of the institution, many SIFI supervisory teams have useful impressions of board performance or institutional culture. Often this information is not consolidated and synthesized in a useful way at a senior level to permit effective supervision. These impressions could also be beneficial to board members if communicated in a manner designed to foster improvement.

Supervisory assessments of board effectiveness require a larger-than-usual component of judgment

**Supervisory assessments
of board effectiveness
require a larger-than-usual
component of judgment.**

compared to other supervisory assessments. But that should not deter supervisors. Methodologies can be developed that have integrity; avoid unfair, differential treatment of institutions; and can be sufficiently grounded in observations to have credibility. But recognizing the limits of judgment means care in demanding change or prescribing how that change should occur.

Based on the ten key roles and effective behaviors outlined in the G30 report, *Toward Effective Governance of Financial Institutions*, the G30 has developed an illustrative template for a structured discussion between boards and supervisors on board effectiveness. The template, and observations on how it could be used, is presented in Appendix 2.

8. For consistency across major institutions in board-level matters, and to promote improvement, supervisors need a robust internal quality assurance process and a better internationally consistent process, and need to actively seek feedback on their performance from industry, including from board members.

A number of supervisors have internal quality assurance processes before supervisory findings are issued, comparing key supervisory judgments and ratings across teams responsible for different SIFIs. Some have an after-the-fact internal audit of supervisory processes. Some conduct confidential surveys of stakeholders, publish the results, and use the results to prioritize areas for improvement. These surveys cover issues such as professionalism of engagement, knowledge of staff, and timeliness of actions. Since supervisors focus more on board-level matters, including boards in the survey process would be valuable. Various supervisors have other processes that board members may use to provide constructive feedback on the supervisory experience. In some cases, the lead supervisor seeks this out, and in other cases, the agency head

seeks informal feedback. It is important that these processes, in whatever form, exist, are used, and are seen as valuable.

The G30 supports all of these approaches as good practice.

9. Policy makers need to strengthen and focus IMF and FSB supervisory assessments.

The IMF conducts periodic independent assessments of countries against internationally agreed principles for effective supervision. To increase their impact and usefulness, they should better highlight the key issues in a country (such as supervisory resources or independence) and elevate discussion

of these at the IMF Board, in public reporting, and reporting to the FSB. The IMF could ensure that capability exists in teams doing annual surveillance (so-called Article IV reports) to better follow up on these key issues. FSB follow-up country peer reviews could be better linked to IMF findings. The FSB could receive an annual report on trends and progress on key supervision issues and themes, including information on specific countries.

Independent assessments or peer reviews conducted by the IMF or FSB, as they relate to governance, should periodically include the results of discussions with a selection of SIFI board members as part of the assessment.

WHAT BOARDS SHOULD CONTRIBUTE

Boards of financial institutions need to welcome interaction with high-quality supervisors, view such interaction as contributing to board effectiveness, and understand that it is the responsibility of the supervisor to seek reasonable assurance that the board is effective and the institution's risk culture is appropriate and to help the supervisors fulfill that responsibility. Boards need to make enhancing supervisory relations a priority and take specific action to support the new paradigm recommended in this report.

The board of directors plays the pivotal role in governance and balancing the interests of multiple stakeholders. The G30's report, *Toward Effective Governance of Financial Institutions*, strongly advocated that boards focus on strategy, risk governance, and the quality of management, and guard against spending too much time on compliance activities. Given this mandate, and given postcrisis supervisory realities, forming productive working relations with supervisors should be a high priority for boards.

That does not mean boards and supervisors should always agree, but the alignment of interests is considerable. Boards are best placed to understand the public interest objectives of good supervision,

and to take that into account in building and maintaining the new paradigm in relations.

Boards also set the tone from the top on how the institution deals with supervisors and whether it is open to supervisors, so that they can do their job effectively and efficiently. Boards also set the tone as to whether supervisors' concerns are treated seriously.

Boards should also see supervisors as a valuable source of industry intelligence—a source that can provide benchmarking information on how an FI's practices compare to those of similar institutions, and information and observations regarding the culture and other aspects of their organization.

In order for boards to contribute to the relations recommended in this report, the following actions are required.

1. Boards of SIFIs must have members who have ongoing relationships with supervisors and who are versed in matters of interest to the supervisor.

Board members often underestimate the time commitment involved in serving on a board, especially for those in key leadership positions, and a greater time commitment by certain board members is inevitable.

It is crucial that board members be adequately prepared for productive discussion with supervisors. This requires the appropriate attitude and approach. Boards must understand the regulatory and supervisory shift that is unfolding, and they need to adapt to the new reality. They should be positioning the FI for change, and their discussion with supervisors should demonstrate that they understand the issues.

Boards need risk and financial institution experience, among other skills, to be able to effectively interact with supervisors. This should be taken into account when making appointments to board leadership positions.

2. Boards need to understand how their structure helps or hinders relations with supervisors.

It was the opinion of a number of supervisors who participated in this study that effective interaction with the boards of major banks was easier when the position of chair of the board and CEO were split. The G30 reaffirms its position, stated in the *Effective Governance* report, that “there is a compelling logic for splitting the two roles” (p. 33). Asking one person to fulfill both roles seems unreasonable, and combining the roles concentrates too much power in a single person. The G30 believes the supervisory judgment noted above has merit,

and further supports the case for a split. Where the positions are not split, the lead director or senior independent director must be actively engaged in discussions with supervisors.

Dual board structures have an inherent separation between oversight and executive management, with all members of the supervisory board being independent. It is key that these board structures ensure that adequate, timely information flows to supervisory boards to assist them in interacting with supervisors.

Board members of SIFIs should interact with the home supervisor, but also with the other *core* host supervisors for the financial institution group (though normally on a less regular basis than with the home supervisor). (See box 2 on page 36 for a discussion of the role of the home supervisor.)

A particular challenge occurs when major banks are subject to supervision by multiple prudential and conduct authorities, each of whom wishes to have interaction at the board level. This is likely to increase as market conduct authorities focus more on internal culture.

The primary interaction of boards will normally be with the prudential authority.

Forming productive working relations with supervisors should be a high priority for boards.

3. Boards should oversee management’s relations with supervisors, and ensure that senior management includes people who are able to foster high-quality relations with supervisors, and that one of the CEO’s direct reports has overall responsibility for group-wide supervisory relations with the FI’s main regulators.

Boards should satisfy themselves that, overall, supervisory relations are constructive, while recognizing that there will be areas of tension. They should frankly discuss their relations with their home supervisor. The management lead for supervisory relations should be a member of the CEO’s senior management committee.

The board should oversee management's response to supervisory recommendations and requirements. Promptness and completeness are essential. Boards set the right tone from the top when they follow up to ensure that compliance issues are dealt with promptly and fully, and that there are appropriate consequences for those responsible, if they are not. To be effective, the response to supervisory findings should not be treated as only a compliance exercise. Board members should also satisfy themselves that they and management look for root causes. Supervisors must help by providing their perspective on root causes. Boards should ask themselves and management whether supervisory findings in one area might be relevant elsewhere.

4. Boards need to devote sufficient time to understanding supervisory, as opposed to regulatory, methodologies and priorities.

Boards need regular education sessions on supervisory methodologies and expectations (to complement what they are already generally receiving on regulatory issues). That will help them do a better job, including when they consider adequacy of resourcing of risk and control functions. Supervisors have a duty to assist boards in this necessary education process.

5. Boards need to focus on their own effectiveness, and that self-assessment should be grounded in an understanding of and demonstration of effective board behaviors. Boards should be continuously seeking to improve their corporate governance practices.

Boards should ensure that their own self-assessment process fully considers areas of interest to supervisors (which ought to be of interest to boards, as well). The process should frankly consider whether there is room for improvement.

More focus on frank assessments of performance, and acting on areas that need improvement, are key.

It has become standard practice for boards to conduct self-assessments, as recommended in the G30's *Effective Governance* report. While these are valuable, effective behaviors of boards of SIFIs are so important to the success of these institutions, and to their safety and soundness, that extra steps are warranted. More focus on frank assessments of performance, and acting on areas that need improvement, are key.

The template presented in Appendix 2 contains illustrative questions based on the G30's ten identified tasks for effective boards, as presented in the *Effective Governance* report. Boards would do well to regularly ask themselves these kinds of questions, not just to prepare for discussion with supervisors, but to ensure their continued effectiveness.

6. Boards should be proactive in engaging supervisors in formal discussions about board effectiveness.

As noted elsewhere, the ideal model is one in which supervisors have a high degree of confidence in the performance of boards and can rely on them. That means that boards need to be able to talk about their effectiveness in areas that matter to both themselves and supervisors. Boards need the ability to bring examples to light that illustrate effectiveness. That goes beyond what is normally included in self-assessments.

Effectiveness assessments and discussions should center around the three most important factors the board controls: the choice of strategy; the assessment of risk taking; and the assurance that the necessary talent is in place, starting with the CEO, to implement the agreed strategy. Boards should be able to give and explain concrete examples of effectiveness as part of this structured discussion. Cases of governance in action may include board-management interaction outside the boardroom, reflecting how boards operate on a day-to-day basis over a longer time frame.

The template presented in Appendix 2 on page 47 is a good basis for a structured dialogue. Supplemented by other supervisory material, it is possible to obtain a reasonable assessment of

whether boards are or are not working effectively. Boards that are truly effective and understand what effectiveness is will find it easy to demonstrate this to supervisors.

BOX 2: THE ROLE OF THE HOME SUPERVISOR

A “home supervisor” is the supervisor from the jurisdiction in which an FI is incorporated or its head office is located, as applicable. A “host supervisor” is a supervisor from any other jurisdiction where the FI conducts business activities.

One of the key challenges in current supervisory arrangements is that large SIFIs are typically supervised by multiple agencies, with interactions taking place through various business units or departments in their organization. Multiple agencies can also exist within one jurisdiction, depending on the national arrangements, adding further complexity. Multiple agencies can also exist within one country, depending on the national arrangements.

This situation has the potential to create confusion and, in some cases, conflicts, in supervisory expectations. In addition, lack of coordination among various agencies can lead to redundant work, tension among supervisors, and missed opportunities to effectively oversee the FI. This situation is likely to become more challenging in countries that implement formal ring fencing of part of major FI operations within their country, including separate independent boards for, say, ring-fenced retail or wholesale operations.

All of these issues present a significant challenge to the new proposed paradigm the G30 is advocating for FI boards and supervisors. SIFIs have a group-level board and often boards with non-executive members for certain subsidiaries.

Major SIFI boards have various forms of interaction between board members and the major home and major host supervisors. One arrangement that appears to work is for certain members of the group-level board to interact with key supervisors of material subsidiaries on group-level governance issues that concern the subsidiary regulator, while subsidiary boards deal with any issues affecting their responsibilities with their direct supervisor. It is unclear at this stage whether that approach will be possible in the various forms of ring-fenced institutions now being considered.

The G30 recommends that the home supervisor responsible for a SIFI institution oversee coordination and consistency of communications, and play a coordinating role in the home and hosts working to avoid inconsistent actions, or inconsistent actions from separate supervisors within one jurisdiction. This relationship management role should not subvert the responsibilities and role of local supervisors, but rather should support it by ensuring that feedback and expectations are coordinated across the group. In addition, the home supervisor should play a central role in all significant communications to the group board and CEO.

Home and major host supervisors of SIFI institutions should redouble their efforts to communicate and coordinate effectively with each other on a regular basis.

CULTURE AND ETHICAL STANDARDS

Boards must understand the culture of their organization, and must be vigilant in watching for serious culture issues that need rectification. This applies especially to identifying risky culture and acting quickly to deal with it. While an institution's broader culture affects its attitude toward risk taking, attention to risk culture must be a priority because it has the most direct connection to safety and soundness. Boards should ensure the compensation system supports the desired culture, discuss culture at the board level and with supervisors, and periodically use a variety of formal and informal techniques to monitor risk culture. Supervisors should share their observations about the institution's risk culture with the board. Supervisors and policy makers should be cautious about writing rules or guidance about culture, and should set realistic expectations about what they can achieve.

Culture is the understood behaviors and attitudes in an organization, based on the systems and messages that reinforce them or undercut them. In the words of those who consider safety culture in major complex organizations, “It is the product of individual and group values, attitudes, competencies and patterns of behavior that determine the commitment to and style and proficiency of an organization’s risk (safety) approach.”⁶

The G30’s *Effective Governance* report states that “values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of the governance arrangements” (p. 76). Culture is the internal compass that guides individuals’ behavior when no one is looking. It involves soft features that defy quantitative measurement, but they cannot be ignored.

There is no one culture that is appropriate for a major FI. Any culture can fail. A deficiency or failure of culture can be as destabilizing to an institution as problems of capital or liquidity, and there are extremes of culture that, unchecked, risk creating major problems. Therefore, extremes or serious problems need to be identified and addressed quickly by boards and, if not by them, by supervisors. Culture within institutions needs to be better recognized and factored into decision making, and considering culture, together with governance and business strategy, is an essential part of forward-looking supervision.

Culture is closely aligned with business model. Management, boards, and supervisors should carefully consider whether the business model reinforces a healthy culture. Business strategies and models that focus on sales rather than customers, short-term results rather than long-term value, growth rather than sustainability, and low

cost rather than efficiency, can create unhealthy cultures. It can be very difficult to change the culture without also changing the business model.

The risk culture of individual institutions will naturally be embedded in the institution’s overall culture and in the financial culture of the country.

Because of the nature of culture, supervisors and regulators (and the international standard-setting bodies) should structure whatever they do in a way that avoids being taken as a detailed prescriptive approach that could become a compliance-only exercise.

The realistic expectation of supervisors’ interventions should be to deal with potentially seriously problematic cultures (outliers) that are not adequately mitigated and that boards have not dealt with. Understanding culture more broadly at major institutions is valuable. But supervisors should avoid attempts to make granular cultural distinctions between one firm and another. There is no one FI cultural ideal. To expect more than this is to ask for the undoable, to waste scarce resources, and to lead to excessive intrusion into how banks are run.

Cultural issues are not unique to financial institutions. Other complex businesses that touch many people, and where failures can be catastrophic, pay attention to organizational culture issues. There is considerable research and practical literature on safety culture in energy businesses, airlines, and health care, among others. Many have developed tools, including surveys and focus groups, to monitor and assess culture. Some FIs are beginning to use these tools. Human resources committees in major banks also often have important information on culture from performance assessments and internal employee surveys, including 360 assessments⁷ of leaders, if the organization conducts

There is no one culture that is appropriate for a major FI.

6 This definition was first provided in 1993 by the UK Health and Safety Commission and has been widely adopted across many industries. See http://en.wikipedia.org/wiki/Safety_culture.

7 In 360 assessments, superiors, peers, and subordinates provide input on work performance.

them. Financial industry participants should look outside the borders of finance for good ideas on assessing and promoting the culture desired.

Boards need to set the desired tone from the top and have their culture and their ongoing actions reinforce the tone they have set. A culture of openness and mutual respect between management and the board is essential.

Research conducted for this report indicates that boards of institutions that have had major breakdowns in part due to culture issues have embraced an awareness of cultural issues and have become aware of drivers of culture. They have embarked on cultural change programs, often linked to changes in the business model that they recognize are not simple, short processes. Boards of other major FIs appear to be aware of the issues, but are taking a less proactive approach.

Consistency of message is hugely important in setting and reinforcing culture. How management leadership and the board approach high-profile decisions (and what communication occurs about why key decisions were made—both to do something or not to do something) sends powerful cultural messages, as do compensation and promotion decisions.

Supervisors' thinking about how to engage on culture issues is also at an early stage, although some reported that they do discuss culture with board members.

The Supervisory Intensity and Effectiveness Group of the Financial Stability Board is considering indicators of risk culture. Culture is not amenable to many traditional supervisory techniques. Boards receive various formal and informal indicators. Some of the many possible indicators may be risk management indicators rather than true culture indicators. Those can be useful contributors to the discussion of culture, but may need to be supplemented by other cultural aspects. Boards and supervisors can synthesize the root causes in these indicators to assess findings about culture.

**Boards need to set the
desired tone from the top.**

Board members and supervisors generally understand that communicating about risk culture could be mutually beneficial, but they are keenly aware of the challenges. Given the state of supervisor-board interactions, work on culture should proceed incrementally while trust and capability in board-supervisor relations are strengthened. There are specific things that supervisors and boards should do.

1. Supervisors and boards should use a short list of simple descriptors of culture, both “good” and “bad.” Using this kind of taxonomy helps boards identify their own FI’s unique culture, better understand its benefits and risks, and assess whether mitigants are in place. Boards (and supervisors) should not take it for granted that they know what the culture of the institution is or that desired behaviors are well understood by staff.

For major FIs, when board members or supervisors talk about culture, they rightly are focused on risk culture, or for conduct supervisors, the culture of how customers are treated. Treatment of customers, if seriously or pervasively problematic, is also an issue for prudential supervisors. That amounts to operational risk breakdowns with reputational risk consequences. While these areas of focus are appropriate, supervisors should also be aware of the broadest aspects of culture to ensure a comprehensive, forward-looking perspective on an institution.

Useful descriptors of desired culture include: valuing risk awareness across the FI; sustainability; client-focused; integrity; accountability; independence of thought; respect for the views of others; transparency; doing the right thing; balanced decision making; open to constructive challenge, including from subordinates; viewing risk management and compliance as adding value; culture of ownership of risk and compliance in both

the business and control functions; collaboration across functional groups; innovation; excellence in execution; learning from mistakes; inclusion of others; conservative; and prudent or cautious.

While these traits appear to be uniquely desirable, they can also be problematic in certain circumstances; for example, too conservative or cautious a culture can lack the dynamism needed for success, which in turn is a key bulwark of safety and soundness. Again, as an example, the organizational culture literature has identified that an excess of collaboration can produce groupthink, which itself can pose risks.

In contrast, various people interviewed for this report suggested elements of culture that can be problematic. Examples include: growth for growth's sake, an excessive sales- or cost-focused culture, an overbearing CEO (or business line head), an unduly deferential culture, an excessively aggressive culture that does not adequately consider whether the identified goal is the right thing to do, cultures that push business while disregarding risks and controls, an ego-driven or star-performer culture, hubris, seeing policies and limits as items to be gamed, siloed cultures, and excessively valuing autonomy over control and adherence to policies.

Aspects of culture that could prove problematic can be mitigated. For example, some bemoan the powerful short-term-performance-driven-CEO culture. But organizations do need active, engaged CEOs who can push change and achieve complex strategies for success (which is important for safety and soundness). The downsides of this culture can be mitigated by an equally strong board, with highly effective challenge, including the counterweight of a very strong chair.

The attitude of the organization toward the supervisor is often an indication of its culture. So is how risk appetite is implemented and used—is it a symbolic statement without substance or is it a valued guide to strategy and business decisions?

The attitude and style of the board, CEO, and senior management team set key examples. So does tone from the top from middle management. The degree to which actions are consistently aligned reveals more about the real culture than do statements of ethics and values (though many report these statements are valuable tools for internal communication and direction setting, if backed up by the desired behaviors).

Some emphasized that culture is determined by what is celebrated in the organization as much as by what is frowned upon. Performance appraisals of whether individuals have adhered to desired behaviors, culture, risk appetite, and other “softer” measures can provide incentives.

Reinforcing the desired culture requires consistent, focused, regular communication. Boards need to be aware of how, and how frequently, the desired culture is communicated by the firm's leadership. A number of major FIs reported that their banks were making culture real to staff through the widespread use of examples of what to do and what not to do. Some were keeping alive lessons learned from their history to inculcate the culture they wanted. Some boards receive reports on significant transactions that were turned down by the firm's risk and control functions as being outside desired risk appetite.

Culture is determined by what is celebrated in the organization as much as by what is frowned upon.

2. Boards and supervisors should understand that assessing culture is about assessing people, individually and collectively, using so-called “soft” skills (that is, effective leadership and values). Independent board members can be uniquely placed to judge culture because of their senior-level experience in other businesses and other walks of life that they bring to the organization. Supervisors can also assess risk culture if they have the right skills, communication ability, and approach.

Supervisors and board members emphasize that culture is not about rules; rather, it is about how the people inside a firm interact and conduct business.

The ability of a board to describe the culture of the organization using a taxonomy such as presented above is a basic feature of any assessment. Board members should look for opportunities to judge culture formally and informally, and should discuss it. This should involve people judgments of the senior staff, as well as actively seeking opportunities to see middle management. Some institutions are doing internal surveys of culture. These can be a useful input, but not the only input, into board and senior management deliberations.

Boards and senior management should also be able to identify examples of key decisions, statements, action plans, strategies, and rewards or punishments that support the desired culture, and they should be able to talk to supervisors about them. That would include actions the board has itself taken.

In many cases, supervisory teams have unique insights into an organization's culture that they pick up in the course of their work and interaction with the organization at many levels. The challenge is to pull these insights together, view a firm's culture at the macro level, and decide if it is so seriously problematic that it requires intervention. Discussions of culture issues with boards that are receptive can be a unique way for supervisors to share concerns and influence the institution's behavior. Supervisors, boards, and management should be vigilant about potentially damaging cultural evolution within the firm.

Supervisors should perform assessments, using such a taxonomy, based on their own observations. Both boards and supervisors should be careful to identify important differences in culture across major parts of the organization. Boards and supervisors should find effective ways to communicate about culture, given the sensitivity of these issues and the potential for misunderstanding.

In many cases, supervisory teams have unique insights into an organization's culture.

The trust-based paradigm presented in this paper should help in that regard.

Discussions about risk appetite, which boards and supervisors are already having, can also be extended to shed light on cultural questions. Discussions of how risk appetite statements are to be interpreted and what falls inside or outside of risk appetite can help illuminate risk culture.

When banks do have risk management breakdowns, root cause analysis can help identify whether culture was a contributing factor.

Boards should discuss culture with risk and control functions and external auditors to obtain their perspective. Compliance functions in certain major institutions are going beyond their traditional role to form judgments on internal attitudes and standards.

3. Boards should determine whether compensation structures and key personnel decisions support the desired culture. Supervisors and boards should discuss how the link between compensation and desired behavior is working.

Culture is about the actions that support the behaviors and values desired and actions that demonstrate what behaviors and values are not desired. Compensation signals what behaviors the organization values and celebrates, and what behaviors the organization does not value. So do decisions on promotion and hiring, especially senior-level hiring.

Boards should satisfy themselves that the compensation system imposes appropriate consequences for transgressions of risk appetite, limits, or policies. This approach should also apply to risk and control functions and to senior management whose behaviors do not meet the desired culture of the FI. Of course, serious breaches are grounds for dismissal. But short of that, reduced compensation for less serious breaches sends an important message. Actions that support the desired culture in challenging circumstances should be rewarded.

Key questions for boards and supervisors to discuss should include: How are risk appetite, limit transgressions, and mistakes handled? How are efforts by staff to raise difficult risk issues recognized? Are there serious whistleblower incidents that are useful indicators? How are whistleblowers treated? Is cultural fit explicitly considered in key senior and midlevel hires? If so, how? Who is the FI promoting to senior positions and what culture

statement does that send? Boards should understand and be satisfied with the answers to these types of questions, and supervisors should be able to discuss the answers with boards.

The board should also satisfy itself that aspects of the compensation system, such as deferrals, clawbacks, and the use of at-risk paper, support the desired and appropriate culture.

WHAT OTHERS HAVE SAID ABOUT SUPERVISORY-BOARD RELATIONS

In assessing lessons learned from the global financial crisis, one of the dominant issues throughout the literature is that of governance. A great deal has been written on the topic since the crisis, particularly regarding how inappropriate governance practices, at the management and board level, contributed to the unchecked buildup of risk, which ultimately led to the crisis. Many also look at what a more appropriate governance structure should look like for financial institutions (FIs), with reports such as the Salz Review,⁸ the Walker Review,⁹ and Mehran and Mollineaux¹⁰ as important examples. In addition, a growing body of literature is attempting to highlight the implications for supervision on governance.

STRUCTURAL CHARACTERISTICS OF GOOD GOVERNANCE

Authors have attempted to distill hallmarks of effective governance of FIs. There is a range of attributes.

A clear definition of the roles and responsibilities of the chairperson and directors is crucial. The board as a whole should, for example, *“approve and oversee the implementation of the bank’s overall risk strategy...internal controls system, corporate governance framework, principles and corporate values,...and compensation system.”*¹¹ The chairperson plays a crucial role in overseeing and coordinating the work of the Board. He or she should have sufficient experience and knowledge for the role and be able to dedicate a significant amount of time to the role. As far as legally possible, separation of the role of CEO and chairperson is desirable, because *“combining both functions disregards the divergence of duties and capacities and concentrates an unwarranted amount of power and dominance in the hands of one person.”*¹²

The composition of the board should focus on ensuring a high level of overall capabilities. *“The board collectively should have adequate*

8 Salz Review 2013.

9 Walker Review 2009.

10 Mehran and Mollineaux 2012.

11 Basel Committee on Banking Supervision 2010, p. 8.

12 European Commission 2010b, p. 8.

knowledge and experience relevant to each of the material financial activities the bank intends to pursue in order to enable effective governance and oversight.”¹³ The establishment of dedicated committees for key topics (audit, risk, and so forth) can help ensure appropriately qualified board members are selected. “The board should establish committees, where appropriate, to improve the effectiveness, efficiency, quality and independence of board decision-making, and enhance the oversight and governance of the insurer.”¹⁴

Ensuring board members are able to allocate sufficient time to their roles is necessary, although in practice few jurisdictions go as far as limiting the number of positions one person can hold. “Instead of a strict limitation of the number of mandates, there should be a general principle that directors devote sufficient time to their duties in a financial institution. The implementation of this general principle by financial institutions should be subject to monitoring by shareholders and supervisory authorities.”¹⁵

Continual assessment of the performance of both the board as whole and individual members is important. “To support board performance, it is a good practice for the board to carry out regular assessments of both the board as a whole and of individual board members. Assistance from external facilitators in carrying out board assessments can contribute to the objectivity of the process.”¹⁶ Finding a way to incorporate the results of these findings into the work done by supervisors in an effective way is important. However, care must be taken to ensure potentially negative information is not unnecessarily disclosed, since this will likely lead to less honest self-evaluations. “There is also a strong preference not to disclose the results to the shareholders. The main argument

for this is that if the results of the evaluation were publicly disclosed, it would inhibit directors' openness to the evaluation process and significantly undermine its value.”¹⁷

To effectively perform their duties, boards need a high degree of access to and visibility of the risk and control functions at the institution. “The board and risk committee are able to receive information, both formally and informally, directly from the CRO [chief risk officer] or the risk management function.”¹⁸ While the role of the CRO has been strengthened since the crisis, ensuring he or she has a direct reporting line to the board or its Risk Committee rather than just the CEO could further strengthen independence. According to a European Commission consultation with EU financial institutions, “the majority [of FIs consulted] consider that the chief risk officer should either have a duty to report directly to the board or to the risk committee on a regular basis or should be able to do so if needed.”¹⁹

SUPERVISION BEYOND FORMAL REQUIREMENTS

Although structural aspects of governance are important, much of the literature also highlights that they do not guarantee desired outcomes.

Indeed, an excessive focus on formal requirements risks leading to compliance-centric supervision, focused on box-ticking rather than a meaningful assessment of effectiveness. “When evaluating individual banks, supervisors should consider that banks will need to adopt different approaches to corporate governance that are proportionate to the size, complexity, structure, economic significance and risk profile of the

13 Basel Committee on Banking Supervision 2012, p. 10.

14 Organisation for Economic Co-operation and Development 2011, p. 23.

15 European Commission 2010b, p. 7.

16 Basel Committee on Banking Supervision 2010, p. 11.

17 European Commission 2010b, p. 9.

18 Financial Stability Board 2013, p. 19.

19 European Commission 2010b, p. 12.

bank.”²⁰ The focus should be on ensuring sound outcomes, based on the internal governance model that is suitable for the particular institution. “In the post-crisis analysis, there is a concern that some supervisory authorities focused their risk assessments more on processes and characteristics than outcomes.”²¹ Furthermore, to be effective, the responsibility for the governance processes of an institution must rest with the board, which should lead by example. “A demonstrated corporate culture that supports and provides appropriate norms and incentives for professional and responsible behaviour is an essential foundation of good governance. In this regard, the board should take the lead in establishing the ‘tone at the top’ and in setting professional standards.”²²

Many of the drivers of effective governance cannot be easily captured in formal frameworks, and evaluation of them thus requires more subjective judgment. “Determining and ensuring the true effectiveness of a board can sometimes be elusive. In the absence of tangible evidence of effectiveness or the lack thereof, a supervisor’s activities and assessments of boards might default more to the regulation and evaluation of characteristics of the boards and their processes versus having a robust evaluation of the boards leading to a true assessment of effectiveness.”²³ Examples of these types of characteristics include leadership style of the chairperson, other behavioral qualities and interpersonal dynamics, and the board’s relationship with the CEO.

The more judgment-based approach required by the supervisor to assess an institution means that frequent interaction between the supervisor and board will be necessary. To this end, “different approaches currently employed by supervisors globally to improve board effectiveness

[include] ... periodically interviewing each director individually to get a sense of how informed and proactive they and their peers have been, having supervisors attend and observe SIFI board meetings ... [and] ensuring regular communication with boards to discuss the most recent supervisory findings.”²⁴ This communication can take the form of formal interactions, but to be truly effective will likely need to include significant informal contact, as well. “Supervisors and firms need to balance formal communication with more regular, more informal communication at all levels.”²⁵

RELATIONSHIP OF BOARDS AND SUPERVISORS

An important area that has generally received too little attention is the potential that lies in more systematically aligning the responsibilities between boards and supervisors, although “Achieving Effective Supervision: An Industry Perspective,” by the Institute of International Finance (IIF), and “Intensity and Effectiveness of SIFI Supervision,” by the FSB, partially cover the topics. Both parties would have a lot to offer the other in a situation where cooperation works smoothly. “Firms and the authorities have a powerful shared interest in achieving effective supervision. For the authorities, supervision is an essential tool for delivering regulatory objectives rather than merely ensuring compliance with the letter of regulation.... For firms, supporting and fully engaging with effective supervision contributes to the provision of a long-term stable environment in which to carry on business.”²⁶

An increasing amount of a board’s time is spent looking at issues around the strategy and business

20 Basel Committee on Banking Supervision 2010, p. 31.

21 Financial Stability Board 2010, p. 7.

22 Basel Committee on Banking Supervision 2010, p. 8.

23 Financial Stability Board 2010, p. 9.

24 Ibid., p. 9.

25 Institute of International Finance 2011, p. 30.

26 Ibid., pp. 15–16.

model of the institution. The move toward more forward-looking supervisory practices is leading many supervisors to dedicate more resources to this analysis, as well. Combining the in-depth, institution-specific insight of the board with the peer group and industry perspective of the supervisor will lead to both being better able to assess the institution's practices. *"[The] approach being promoted in this report would see Board members and senior management subjected to much closer scrutiny in these areas.... In many cases it is likely that the supervisor, with their sector-wide perspective and the benefit of specialist advice, will be satisfied with regard to the role of the Board and its members. If this is not the case, however, they would insist on having a channel to the Board Chairman and/or CEO to discuss what they see as deficiencies."*²⁷

Closer cooperation would also benefit a supervisor's ability to verify that sufficient governance practices are being maintained, and a board's ability to show it. In particular, moving away from

the *"excessive supervisory emphasis on the existence of governance structures"*²⁸ toward one with sufficient *"attention to the much more difficult issue of the effectiveness of these"*²⁹ will require close and open communication. Interviews and discussions with board members and a focus on the board providing concrete examples of effective governance will be crucial.

Finally, both boards and supervisors will benefit from a greater mutual understanding of issues around culture. *"If trust is to be rebuilt, firms and supervisors need to work together to leverage and reinforce sound industry practices. There needs to be a culture of cooperation throughout the firm and industry."*³⁰ Boards will benefit from the supervisors' industry-wide insights into successful aspects of culture at other firms and from greater realization among supervisors of the need to judge each institution's culture individually. Supervisors will benefit from a board that actively challenges its institution's culture and has obtained a breadth of knowledge related to the topic.

27 Ibid., p. 24.

28 Ibid., p. 24.

29 Ibid., p. 24.

30 Ibid., p. 28.

AN ILLUSTRATIVE TEMPLATE FOR ASSESSING BOARD EFFECTIVENESS

This appendix provides an illustrative template for supervisors and boards to use when assessing board effectiveness. It is based on the enumeration of effective board behaviors in the G30's previous report, *Toward Effective Governance of Financial Institutions*. There is no one set of "correct" answers to these areas for discussion, and the template should be used as a tool to gauge the board's collective expertise. Supervisors should be looking for a broad-based understanding by board members of the issues, and plausible explanations of how they are being addressed; they should not expect each board member to have detailed expertise in all the areas covered. The critical question is

whether the board *collectively* has the expertise to effectively oversee the institution. Thus, a particular board member's lack of detailed expertise on a particular topic is not necessarily a problem. The desire of board members to improve, with a plan in place, should be seen by supervisors as evidence of effective governance in action, not as a sign of weakness.

The specific questions in the template are not meant to be definitive, but rather to illustrate that a process like this can work and can yield useful results. And supervisors will understandably want unscripted discussion, as well.

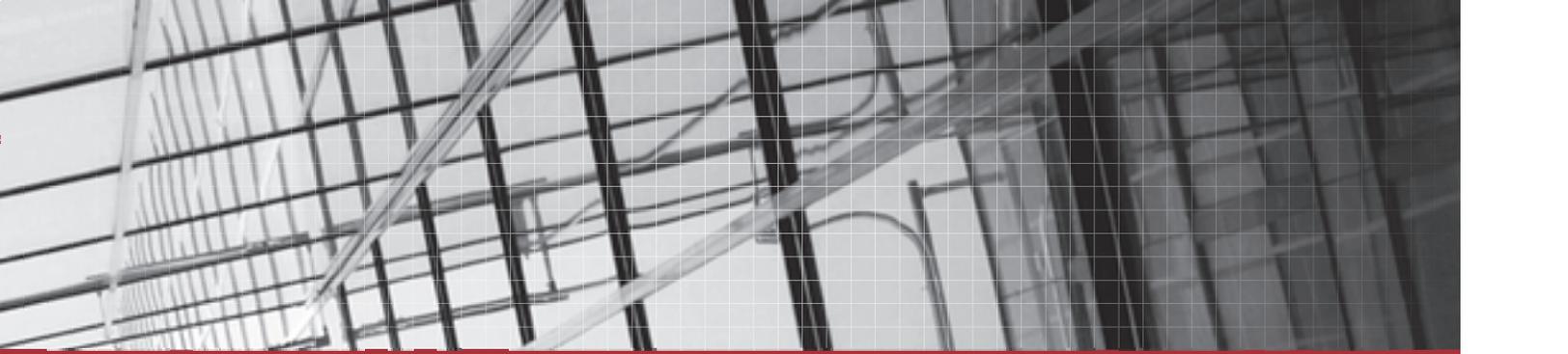
Boards can use elements from this template to enhance consideration of their own effectiveness.

ILLUSTRATIVE TEMPLATE FOR ASSESSING BOARD EFFECTIVENESS

ESSENTIAL TASK	POSSIBLE STRUCTURED DISCUSSION POINTS
<p>Fashion a leadership structure that allows the board to work effectively as a unified team.</p>	<ul style="list-style-type: none"> ◆ How are board discussions organized? ◆ How does the chair ensure opportunity for participation? ◆ How could a board member raise an issue about how the board is operating? Has that happened in the last few years? ◆ Are there major decisions you feel could have had more thorough discussion? ◆ Are there board members who participate in discussions much more than others?
<p>Recruit members who collectively bring a balance of expertise, skills, experience, and perspectives, and who exhibit irreproachable independence of thought and action.</p>	<ul style="list-style-type: none"> ◆ Can you, as board chair, give me a sense of how the experience, skills, and perspectives you want are met with your current composition of board members? ◆ How does that compare with your view of the strategic and risk challenges the board sees for the FI over the next five years? ◆ How do you use the various skill sets and experience in the board's operations? ◆ How do you ensure the collective capabilities of the board are sufficient to fill key leadership positions such as chair and chairs of key committees? ◆ Are there particular skill sets you would like to add? Or, given the move of the FI in this direction, are you considering adding additional skill sets? ◆ Can you offer some examples of how board members recently demonstrated independence of thought (could be in contribution to strategic discussion, a risk or talent issue)? How do you as chair run the operations of the board to facilitate that?

ESSENTIAL TASK	POSSIBLE STRUCTURED DISCUSSION POINTS
<p>Assure board collectively has a nuanced and broad understanding of all matters concerning the strategy, risk appetite, and conduct of the FI and an understanding of the risks it faces and its resiliency.</p>	<ul style="list-style-type: none"> ◆ In-depth discussion with chairs of risk committees and/or members, and with other board members on the risk appetite framework and the major risks the bank faces. ◆ Review the risk appetite framework approved by the board to discuss examples of how it has been used to guide strategy or particular decisions the board has made over, say, the previous year. ◆ Discuss examples of recent discussions the board has had with management as to what the risk appetite means, in practice. ◆ How is risk appetite taken into account in strategic development and strategic transactions at the management and board level? Can you provide some examples of both strategic matters explicitly discussed and considered inside the risk appetite and of ones considered outside?
<p>Appoint the CEO and gauge top talent in the firm, assuring that the CEO and top team possess the skills, values, attitudes, and energy necessary for success.</p>	<ul style="list-style-type: none"> ◆ What is your succession planning process telling you about the depth of talent in the FI? ◆ What are your processes for developing potential successors for various key positions? ◆ Are there areas the board is looking for the CEO to improve? ◆ Are there any skills you think need to be added to the top management team, given the strategy of the FI?
<p>Take a long-term view on strategy and performance, focusing on sustainable success.</p>	<ul style="list-style-type: none"> ◆ How is the organization focusing on the sustainability of performance? ◆ Can you provide an example of where sustainability was explicitly considered in strategy or business decisions?
<p>Respect the distinctions between the board's responsibilities for direction setting, oversight, and control, and management's responsibilities to run the business.</p>	<ul style="list-style-type: none"> ◆ Ensuring appropriate roles for the board and management is important to effectiveness. Has getting that demarcation right been an issue for this institution? ◆ How do you satisfy yourself that this is working? ◆ Under what circumstances would the board think it needed to be more involved than normal? Has that occurred in the last year or so?

ESSENTIAL TASK	POSSIBLE STRUCTURED DISCUSSION POINTS
<p>Reach agreement with management on a strategy and champion management once decisions have been made.</p>	<ul style="list-style-type: none"> ◆ Can you describe the major discussions and issues that were part of forming the strategy? ◆ What was the board's level of involvement? ◆ How is the board overseeing implementation?
<p>Challenge management vigorously and thoughtfully, discussing all strategic proposals, key risk policies, and major operational issues.</p>	<ul style="list-style-type: none"> ◆ Can you provide one or two examples of effective challenge by the board/your committee over the past year? Take me through that—what happened, how did the challenge occur, how did management respond, what was the result? ◆ Take an example of a strategic proposal from the previous year—describe the discussion, how did you make a judgment on the issue, was information adequate, what options were considered? ◆ How engaged is the board/committee in directing the kind of information it wants to see? Can you provide examples of this from the past year? ◆ Using an example from the past year, can you outline various considerations and discussion of a particular risk policy you considered?
<p>Ensure that rigorous and robust processes are in place to monitor organizational compliance with the agreed strategy and risk appetite and with all applicable laws and regulations. Proactively follow up on potential weaknesses or issues.</p>	<ul style="list-style-type: none"> ◆ How are you overseeing the effectiveness of the risk appetite/control framework? How often during a year do you focus on this? ◆ What information do you get on how it is working? ◆ What would trigger you wanting a more in-depth review of effectiveness? ◆ Can you provide an example of discussions with management about the effectiveness of the monitoring framework? ◆ Does management/the board regularly review material issues that other FIs dealt with for lessons learned? Can you offer some examples?
<p>Assess the boards own effectiveness regularly, occasionally with the assistance of external advisors, and share this assessment with the lead supervisor.</p>	<ul style="list-style-type: none"> ◆ What are the main points you take from the board self-assessment? ◆ How seriously is this taken by the board? Can you describe the nature of the discussion that occurred? ◆ How do you assess the progress on the action plans? ◆ How are the main action items from the survey helping you to be a better board?



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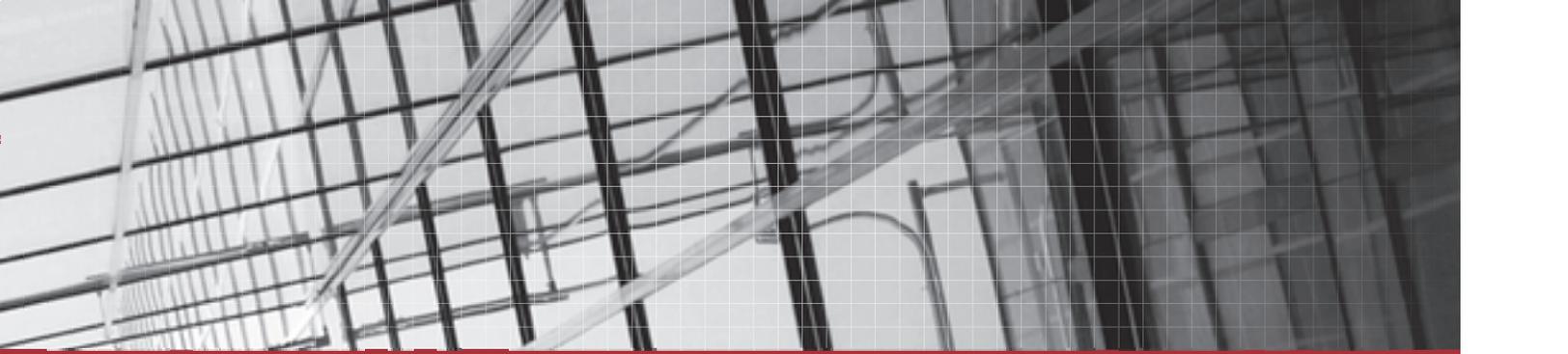
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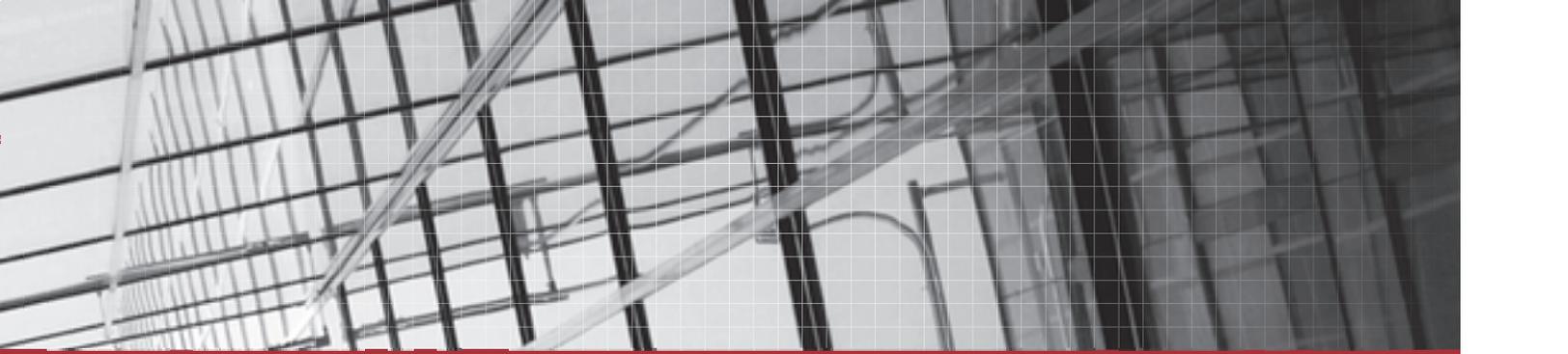
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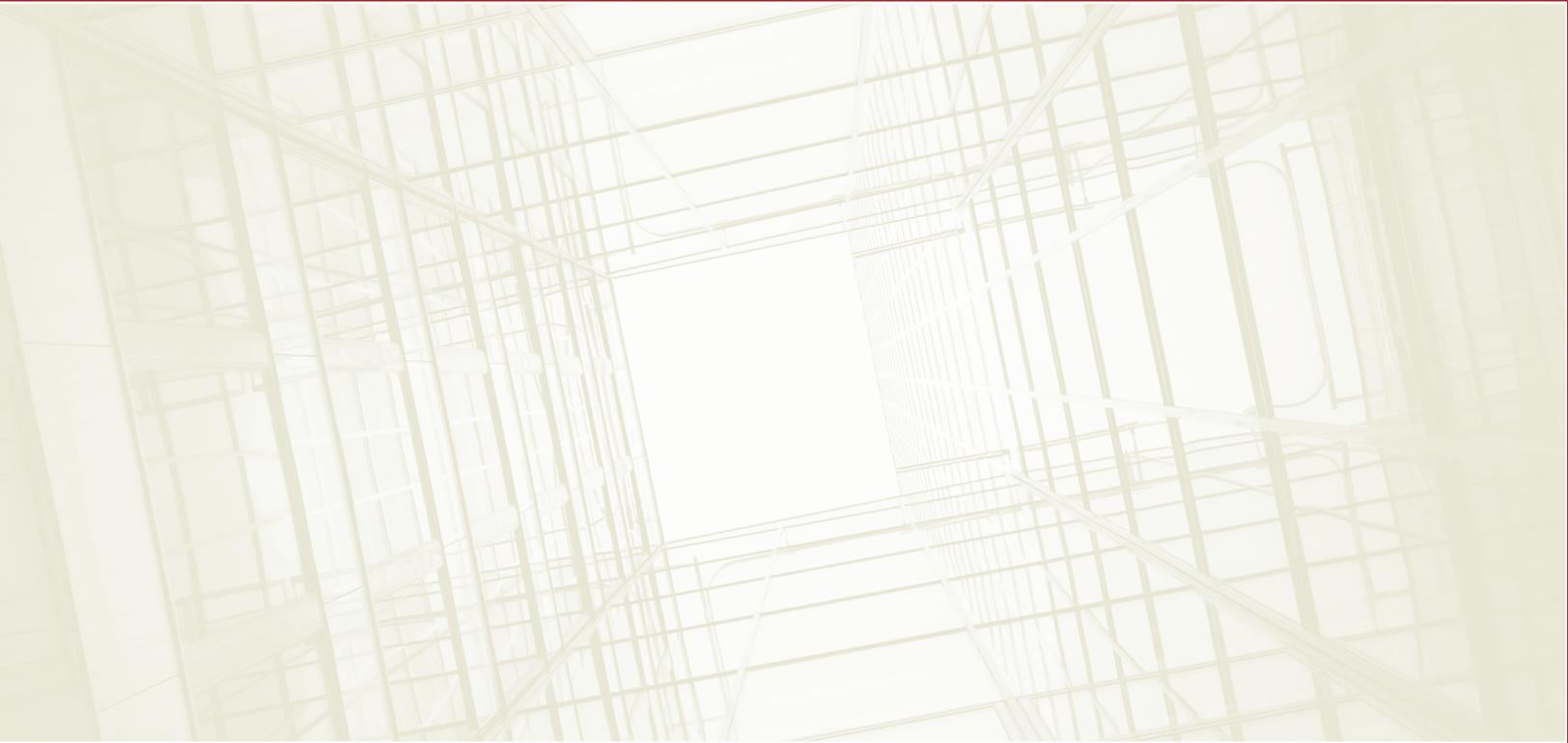
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