# GOVERNANCE OF BANKS IN AN ERA OF REGULATORY CHANGE AND DECLINING PUBLIC CONFIDENCE

Roger McCormick - Andrea Minto*

**ABSTRACT:** *Corporate governance reforms have become more intrusive for banks than might be thought appropriate for "ordinary corporates". "Heavier" regulation in this area is justified by the public interest at stake in bank activity and the risk to the public interest if a bank is allowed to fail (and the cost to the public of saving a bank from failure). The public interest (and the interest of all stakeholders) also has implications for the scope of the duty of care of bank directors.*

*Conventional concepts of corporate governance address traditional risk areas in banking activity as well as tensions such as the "agency problem" and the need for oversight by directors of senior management. However, a new set*

---

* Roger McCormick is a Visiting Professor at London School of Economics and Political Science and the Managing Director of CCP Research Foundation CIC, a social enterprise vehicle that supports and undertakes research in topics related to conduct culture and people in large organizations.

Andrea Minto is Post-doctoral Fellow and Adjunct Professor of Banking and Financial Market Law at Ca' Foscari University of Venice. Although this paper is the result of a joint reflection of the Authors, Roger McCormick is primarily responsible for paragraphs 1 and 6, whereas Andrea Minto is primarily responsible for paragraphs 2, 3, 4 and 5. The paragraphs credited to Andrea Minto reproduce, with some additions, the Presentation regarding "Current risk issues and the challenges of financial undertakings' internal governance", held at the University of Southern Denmark on 19 May 2014.

The author would like to thank the Research Group in "Regulating Financial Business and Services" for the suggestions arising from the debate.

*of issues related to public trust has been triggered by the LIBOR scandal and most banks, and many commentators, profess a desire to "restore public trust" and address acknowledged shortcomings in their approach to ethical questions and the soundness of their corporate culture. A related, but different, set of challenges arises as a result.*

**SUMMARY:** 1. Introduction. – 2. The internal governance concept: an overview. – 3. Nature of the firm, risk management and agency issues: new strategies in regulating the governance of banks. – 4. The "organisational duty" and the upward trajectory of the directors' duty of care and diligence. – 5. Matching board composition to business risks. – 6. Concluding remarks.

1. Six years after the collapse of Lehmans and the onset of the worst financial crisis of the post-war era, there appears, still, to be an ongoing crisis of public trust in relation to how our banks are running. If we take the United Kingdom as an example, we have, in 2014, heard calls for banks to "professionalize" themselves[1], for bankers to be required to swear solemn oaths as to their honesty and behaviour[2] and for businesses generally (but especially banks) to enter into a "covenant" with the communities they serve. It is fair to say that public confidence in banks remains low.

The idea for the "covenant" was put forward in August 2014 by Lord Digby Jones (former UK government minister and former Director-General of the Confederation of British Industry) when he asserted that " ....as we come

[1] See the various publications of the UK's Banking Standards Review.

[2] See the July 2014 publication, "*Virtuous Banking*" by the Res Publica "Think Tank".

out of one of the worst financial crises this country has ever experienced, trust in business is pretty much at rock bottom". Such sentiments have, in recent times, often been expressed in relation to the banking sector (but have also been heard in relation to the energy sector and various parts of the public sector (such as the police and health services)). The desire (and expressed need) to "restore public trust" has become something of a mantra, repeated with ever-increasing frequency in an expanding range of contexts. But where we hear the mantra most frequently is in the context of banking, from the mouths of bank CEOs and Chairmen. The Chairman of the UK bankers' trade organization, the British Banking Authority, said recently: "Restoring trust and confidence is the banking industry's number one priority".

This outbreak of "restore trust" chest-beating was triggered by the LIBOR scandal, which broke in the summer of 2012. That scandal has proved to be something of a watershed. Before it, the crisis had told us that bankers were by no means as smart as we had thought they were: their risk-taking was out of control to the point of recklessness. But after LIBOR we learnt something else. The industry was not only reckless in its habits, parts of it, perhaps large parts of it, had become downright dishonest. The "culture" had been corrupted. The scandal quickly led, in the UK, to the formation of the Parliamentary Commission on Banking Standards (which, ultimately, begat the Banking Standards Review, referred to above) which held a series of searching interviews with senior bankers and published various reports on the theme of ethics and morality in banking. The ethics/culture refrain has been widely taken

up. But where does this leave the somewhat narrower, more technical, field of corporate governance?

On 12th September 2012, Sir David Walker (who in 2009 had authored a government-sponsored review of bank governance[3] and is currently the Chairman of Barclays) gave evidence to the Parliamentary Commission. He acknowledged that standards in banking were low (but also pointed out that there had been other times in recent history when they had been low). But one of the most telling remarks he made was, in referring to his bank governance review, that he was "struck" that he "did not talk much about culture or reputation" in that document. The biggest issues in 2009 had been (he said) concerned with the "survival of banks" and associated risk issues. Those issues (essentially concerned with financial stability) "overshadowed" the questions of culture and reputational risk that the LIBOR scandal had brought to the fore (which Sir David acknowledged were "very serious"). This, very simple but very telling, analysis by a senior, eminent banker of how public attention shifted, in 2012, from "classic" governance issues (i.e. focused mainly on risk management and responsibility for it) to the "morality/ethics/culture" agenda demonstrates very neatly an important aspect of the relationship between what we know as "corporate governance" and corporate culture. In the context of banking, it is no longer sufficient for policy makers to allow focus on the former (important though it is) to exclude attention to the latter, which presents related, but different, challenges. Whilst, in the context of banking, corporate governance may be more concerned with sound management of risks such as credit risk and

[3] See "*A review of corporate governance in UK banks and other financial entities*", November 2009.

other risks traditionally associated with market activity, corporate culture is more concerned with reputational risk and the bank's own sense of what is acceptable (and unacceptable) behaviour. The "crisis of trust", which is directly linked to corporate culture, relates, in simple terms, to how banks are run and, in particular, whether they are run honestly and respectably by people who feel they have some obligation to the society in which they operate that overrides the short-term desire to maximize profit.

Apart from the LIBOR scandal itself, it is worthwhile reflecting on some further examples of bad bank behaviour or culture that have led to the trust crisis. In his evidence to the Parliamentary Commission, Sir David referred to three "strands" that were relevant. The first was the widespread practice (fed by a "commission culture") of mis-selling financial products to consumers (notably, payment protection insurance). The second was the desire of many banks, in the pre-crisis "go-go" atmosphere, to increase market share regardless of price and risk considerations. Thirdly, the huge strides made in technological developments, with expectations of (for example) of rapid responses to complex issues and questions (and the attractions of making quick returns) tended to prioritize ingenuity over integrity. Of course, in the time that has elapsed since Sir David was giving his evidence we have learned of other actual or potential scandals with "LIBOR overtones" in relation to the foreign exchange market and other "benchmark" rates such as Euribor.

And so the "culture" declined. But culture is a tricky, and very vague concept. If banks are trying to restore the situation, it is important that we find ways of testing their success. Fine words alone are not enough. The Conduct

Costs Project[4] offers one approach. If banks are successful in their efforts to improve their conduct, then the cost of poor conduct, as demonstrated by regulatory fines and compensation payments (for example) should start to go down. However, we cannot know if this is the case if we do not keep a log of such costs. That is what the Conduct Costs Project (amongst other things) seeks to do. The Project's findings for ten major international banks for the five year period ending 2013 showed an aggregate conduct cost total of just under £160bn. There is no reason to suppose that the figures for the period ending 2014 will show much improvement. That is a huge figure, so there is evidently some way to go. Banks understandably point out that many of these costs relate to what they now call "legacy issues" but it is perhaps a little too soon to be confident that they really are "legacy" and that the underlying problems have been solved. Other suggested approaches (seeking more "positive metrics") can be found in the Banking Standards Review Report. It remains to be seen whether or not any of these proposals will mature into something more "concrete".

The Conduct Costs Project has already had some influence. In August 2014, the European Banking Authority announced that it would, for the first

[4] Formerly, the LSE Conduct Costs Project at blogs.lse.ac.uk. This project is now transferred to the CCP Research Foundation CIC. Apart from the totals, the project provides data on a bank-by bank basis and also breaks down the various "heads of problem" (e.g. mis-selling, AML issues, US sanctions problems etc.).

time, be publishing bank conduct cost data when it published the results of its latest bank stress tests[5].

If the "trust crisis" is easy enough to identify, finding a solution to it is rather more difficult. The Conduct Costs Project represents a civil society response. Each bank is developing its own response. There does not yet seem to be a cross-industry response but that may develop as the Banking Standards Review progresses its work. What seems to be clear, however, is that, as regards culture, we seem to have reached the limit of what conventional regulation can achieve. We can regulate for corporate governance, for the formation of organizational and reporting requirements and for appropriate risk management. (In short, we can regulate for adequate corporate governance). To regulate for "honest behaviour" and "better culture", however, would seem to be fatuous. A dishonest man will likely be dishonest whatever the law may say. What we can do is work more diligently on the "grey areas" that still exist as to what is or is not acceptable behaviour and we should, it is suggested, encourage banks to do this in consultation with each other on a cross-industry basis.

Although the trust crisis currently preoccupies banks and industry commentators (at least in the UK), the reform process for "traditional" corporate governance rolls on, gathering momentum in the process. The realization that "banks are different" has given added impetus to the need for a

[5] In June 2014, Roger McCormick (as Director of the Conduct Costs Project) had given the keynote speech (on the importance of conduct cost reporting and conduct risk management) at the Consumer Protection Day organised in London by the European Banking Authority and other European Supervisory Agencies.

fresh look at what sound corporate governance means in the context of banks and an assessment of how, and to what extent, the rules that apply to ordinary corporates should be amended and amplified in the case of banks. The most important lesson we have learned from the Crisis is that when banks go wrong it is not only shareholders who may suffer. This justifies a much more rigorous approach to such rules as may apply ion the bank corporate governance area. The issues that such changes give rise to are considered in the sections that follow.

2. As described in the foregoing section, questions about the corporate governance of banks have become closely associated with issues related to "restoring public confidence" or "public trust"[6]. Indeed, the CEOs and Chairmen of many major banks have, particularly since the unfolding of the LIBOR scandal, reminded us at regular intervals that they see the restoration of public trust in their bank as a central part of their mission. The scandals that have emerged following the 2007-2008 Crisis have provoked much reflection on the role and degree of intervention by regulators, substantially shifting from what was perceived to be a "light-touch" towards a heavier approach[7]. Prominent items

---

[6] It is quite expressive the *incipit* of the EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011: «Trust in the reliability of the banking system is crucial for its proper functioning and a prerequisite if it is to contribute to the economy as a whole. Consequently, effective internal governance arrangements are fundamental if institutions, individually, and the banking system, are to operate well». On the need of restoring the lost trust due to the mismanagement, see also the UK Banking Standard Review Report, May 2014.

[7] See WEBER - REY, *Effects of the Better Regulation Approach on European Company Law and Corporate Governance*, in *European Company and Financial Law Review*, 2007, pp. 393 - 394; DALLA

on regulatory agendas are the improvement of both banks' corporate governance systems and the authorities' supervision of them.

Alongside changes to substantive laws and regulation, regulators and policy makers have been reconsidering what can and should be expected of "corporate governance" in the context of banking. There has been a realisation that traditional concepts and associated rules and organizational structures related to "corporate governance" and the classical "agency theory" underpinning the law relating to corporate management and responsibility to shareholders do not really deliver what society expects from financial institutions that depend on substantial direct and indirect support from the taxpayer and that, consequently, owe duties to stakeholders that would not generally apply in a non-financial context (i.e. to an "ordinary" corporate entity)[8].

Redefining the boundaries of what "corporate governance" actually means in the context of banks involves not only a fresh look at its content, which has become blurred over time[9]. It also requires a review of the way a corporation is governed that re-examines the traditional agency scheme mostly focused on the tension between shareholders and management interests. The

---

PELLEGRINA - MASCIANDARO, *Good Bye Light Touch? Macroeconomic Resilience, Banking Regulation and Institution*, in *Journal of Risk Governance and Control*, vol.3, n. 1, 2013, p. 18.

[8] Commenting the recent regulatory changes, it has also been proposed a modification to the corporate governance of system financial firms as to take into account their peculiarities. See ARMOUR - GORDON, *Systemic Harms and Shareholder Value*, in *ECGI Law Working Paper*, 2013, n. 222, p. 5; ROE, *Structural Corporate Degradation Due to Too-Big-Too-Fail Finance*, in *ECGI Law Working Paper*, 2014, n. 253.

[9] See BELCREDI - ENRIQUES, *The European Corporate Governance Framework: Issues and Perspectives,* in *ECGI Law Working Paper*, 2013, n. 214.

legal strategies conceived in the pre-Crisis era to address the agency issues between shareholder interests and management no longer seem adequate as an effective and concrete response also to the issues that the Crisis has raised[10].

Even though, in the aftermath of the Crisis, there have been controversial opinions about corporate governance issues[11], there is much common ground that malfunctioning of the management body has been a key contributory factor to the problems that have been experienced.

The main weakness revealed by the bank collapses was the lack of oversight by the failed bank's management body (i.e. the board of directors), which did not properly perform either its management or its supervisory

---

[10] As regard the increasing attention on organizational mechanisms that were often ignored by the corporate governance models, see McCAHERY - VERMEULEN, *Understanding the Board of Directors after the Financial Crisis*, in *ECGI Law Working Paper*, 2013, n. 229, p. 11.

[11] See, *e.g.*, AKHIGBE – MARTIN, *Influence of Disclosure and Governance on Risk of U.S. Financial Services Firms Following Sarbanes-Oxley*, in *Journal of Banking and Finance*, 2008, p. 2124; KIRKPATRICK, *The Corporate Governance Lessons from the Financial Crisis*, in *Financial Market Trends*, OECD, 2009, n. 1, p. 1; MÜLBERT - CITLAU, *The Uncertain Role of Banks' Corporate Governance in Systemic Risk Regulation,* in *ECGI Law Working Paper*, 2011, n. 179; PATHAN, *Strong boards, CEO power and bank risk-taking*, in *Journal of Banking and Finance*, 2009, p. 1340; BELTRATTI - STULTZ, *Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation*, in *ECGI Finance Working Paper*, 2009, n. 254; ERKENS – HUNG - MATOS, *Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide*, in *ECGI Finance Working Paper*, 2009, n. 249; CLAESSENS – DELL'ARICCIA – IGAN - LAEVEN, *Lessons and Policy Implications from the Global Financial Crisis*, IMF Working Paper, 2010, n. 44; AHRENS – SCHWEICKERT - ZENKER, *Varieties of capitalism, governance and government spending: A cross-section analysis*, in *Kiel Working Papers*, 2011, n. 1726; BERGER – IMBIEROWICZ - RAUCH, *The role of corporate governance in bank failures during the recent financial crisis*, in *European Banking Center Discussion Paper*, 2012, n. 23; BECHT – BOLTON – RÖELL, *Why bank governance is different?*, in *Oxford Review of Economic Policy*, 2012, p. 437; HOPT, *Corporate governance of Banks and Other Financial Institutions After the Financial Crisis*, in *Journal of Corporate Law Studies*, 2013, p. 219.

function[12]. The failure of bank boards to supervise the business appropriately was largely due to difficulties at senior level in grasping the complexity of the business and the risks involved, and the related failure to identify and constrain excessive risk-taking[13]. The need to identify, and keep to, a predetermined threshold of risk tolerance (or "appetite") is at the heart of the decision-making process and to the relationship between the board of directors and senior executives[14]. The resulting allocation of powers entails the separation of tasks between senior management and the board of directors: the execution of business decisions is the province of the former, while the determination of the strategic plans and the monitoring of management performance in the context of those strategies, is the province of the latter[15].

---

[12] We refer interchangeably to the supervisory function and to the monitoring one, even if the former is actually broader than the latter as it oversees the management function and provides advice to it. Its oversight role consists in providing constructive challenge when developing the strategy of an institution; monitoring of the performance of the management function and the realization of agreed goals and objectives; and ensuring the integrity of the financial information and effective risk management and internal controls (see the definition provided by the European Banking Authority, *Guidelines on Internal Governance*, London, September 2011).

[13] Focusing on the risk management role of the board of directors WYMEERSCH, *Risk in Financial Institutions – is it managed?*, in *FLI Working Paper*, 2012, n. 4.

[14] See ADAMS – HERMALIN - WEISBACH, *The role of board of directors in corporate governance: a conceptual framework and survey*, in *Journal of Economic Literature*, 2010, 48, pp. 58 ff.

[15] Obviously, the separation of powers and tasks strictly depends on whether the company has adopted the one-tier or two-tier board structure: for an overview, see WILLIAMSON, *Corporate Board of Directors: in Theory and in Practice*, in *Journal of Law, Economics & Organization*, 2008, 24, pp. 247 ff.; ARMOUR – HANSMANN - KRAAKMAN, *What is Corporate Law?*, in KRAAKMAN et al. (eds.), *The Anatomy of Corporate Law. A comparative and Functional Approach*, Oxford University Press, 2009, pp. 12 ff.

Focusing on the monitoring function of the board of directors, various international bodies[16] have paid increasing attention to the concept of "internal governance". This has led to a marked focus on specific issues in the corporate governance area, for example, the arrangements within a bank for the sound management of risk The definition of internal governance was initially covered by article 22 of the Directive 2006/48/EC, which provided «that every credit institution has robust governance arrangements, which include a clear organizational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management».

In the wake of a growing interest around this topic, the European Banking Authority has shed light on internal governance requirements through *ad hoc* guidelines, arguing that internal governance is closely related to, but different from, corporate governance. The former should be considered as a limited but crucial component of corporate governance, focusing on the internal structure and organization of an institution and especially the delegation of powers to

[16] See BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, October 2010; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELPMENT, *Corporate governance and the financial crisis - Conclusions and emerging good practices to enhance implementation of the Principles*, February 2010; EUROPEAN COMMISSION, *Green Paper on Corporate governance in financial institutions and remuneration policies*, June 2010.

senior management and to the corresponding monitoring function for which the board is responsible.

Directive 2013/36/EU (the Fourth Capital Requirement Directive, hereinafter "CRD IV"), which repealed Directive 2006/48/EC (referred to above), has further developed the regulatory framework in this area in accordance with the European Banking Authority guidelines.

As is well-known, corporate governance measures traditionally stem less from provisions in laws or regulations, which often adopt a high-profile generic formulation, and more from agreed documents and contracts, such as corporate governance codes which may be transposed into appropriate provisions in the articles of association[17]. The last round of changes to European banking law, consisting mainly of CRD IV – and Directive 2014/65/EU as well, but actually with reference to markets in financial instruments and to investment firms (known as "MiFID II") – marked a regulatory *revirement*, steering away from the previous general provisions on risk management and internal control towards a proliferation of more detailed rulemaking, with new mandatory and regulatory determined measures and several specific activity related requirements[18].

Thus, the outcome of the ongoing reform process concerning the regulation of corporate governance is a framework with the objective, on the one hand, to emphasize specific areas – such as internal governance –and, on the other hand, to provide more detailed prescriptive provisions than in the

---

[17] See ARMOUR - RINGE, *European Company Law 1999-2010: Renaissance and Crisis*, in *Common Market Law Review*, 2011, 48, pp. 125 ff.

[18] On these themes, see VAN DER ELST, *The Risk Management Duties of the Board of Directors*, in *Financial Law Institute Working Paper*, Gent University, 2013, 12.

past, resulting, it is hoped, in a more rigorous risk and management regime than resulted from the broad adoption of the "better regulation" technique[19].

In light of the weaknesses in the way financial firms were run, the majority of the recent developments on corporate governance of banks are predominantly focused on improving the working of the management body and on the internal organizational measures that could serve this purpose. It appears that the most recent reforms are concerned less with working out *directly* the classic agency problems between shareholders and managers and more at concerns that are due to the special nature of financial business, since the *risks* involved in running that kind of business are what shape the conduct expected.

What do we mean by "special nature of financial business"? It has often been observed that "banks are different" and, in this context, it is the peculiar risks that financial institutions have to manage and, at the same time, the public interest in successful management of such risks that makes financial business "special"[20]. As recent events have painfully showed, many and multi-faceted

---

[19] See Recital 53 of CRD IV, stating that «the very general provisions on governance of institutions and the non-binding nature of a substantial part of the corporate governance framework, based essentially on voluntary codes of conduct, did not sufficiently facilitate the effective implementation of sound corporate governance practices by institutions».

[20] Banks are different from other firms for several reasons that matter from a corporate governance perspective: see, *e.g.,* MACEY - O'HARA, *The Corporate Governance of Banks*, in *Economic Policy Review*, 2003, 9, pp. 91 ff.; ADAMS - MEHERAN, *Is Corporate Governance Different for Bank Holding Companies?*, in *Economic Policy Review*, 2003, 9, pp. 123 ff.; COCRIS - UNGUREANU, *Why are Banks Special? An Approach from the Corporate Governance Perspective*, in *AI.I Cuza University of Iasi*, Economic Series, 2007, 55; MÜLBERT, *Corporate Governance of Banks after the Financial Crisis — Theory, Evidence, Reforms*, in *ECGI Law Working Paper*, 2009, n. 130; FERRARINI – UNGUREANU,

banking risks involve not just shareholders' interests but also the interests of a wide range of stakeholders, such as creditors, "taxpayers" and the financial system as a whole[21].

A key driver of the reform of corporate governance of banks is therefore the need to consider the wider range of consequences may result from a financial institution's failure and how this affects the directors' duty of care and the duty to establish an effective oversight system[22]. It is no longer tenable to argue that bank's directors owe only duties to shareholders[23]. In reality, they

---

*Economics, politics, and the international Principles for Sound Compensation Practices: An analysis of executive pay at European banks*, in *Vanderbilt Law Review*, 2011, 64, pp. 431 ff. Accordingly to BELCREDI - ENRIQUES, *The European Corporate Governance Framework: Issues and Perspectives,* in *ECGI Law Working Paper*, 2013, n. 214, pp. 11 ff., there are substantially three key factors. First, banks are more leveraged than other firms, with the consequence that the conflict between shareholders and fixed claimants, which is present in all corporations, is more acute for banks. Second, banks' liabilities are largely issued as demand deposits, while their assets, such as loans, have longer maturities. Third, despite contributing to the prevention of bank runs, deposit insurance generates moral hazard by incentivizing shareholders and managers of insured institutions to engage in excessive risk-taking.

[21] See BECHT – BOLTON - RÖELL, *Why Bank Governance Is Different*, in *Oxford Review of Economic Policy*, 2011, 27, pp. 444 ff.; HOPT, *Comparative Corporate Governance: The State of the Art and International Regulation*, in *American Journal of Comparative Law*, 2011, 59, pp. 28 ff.

[22] See JOHNSON, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, in *Seton Hall Public Law Research* Paper, 2011, n. 3; MILLER, *Oversight Liability for Risk Management Failures at Financial Firms*, in *Southern California Law Review*, Vol. 84, 2011, 47.

[23] It has been argued that in the long run the corporate actions might maximize both shareholder wealth and enterprise value: HOPT – LEYENS, *Boards Models in Europe – Recent Developments of Internal Corporate Governance Structure in Germany, United Kingdom, France and Italy*, in *European Company and Financial Law Review*, 2004, 1, pp. 134 ff.; TUSCHKE - LUBER, *Corporate Governance in Germany: Converging towards Shareholders Value-Orientation or not so Much?*, in RASHEED - YOSHIKAWA, (eds.), *The Convergence of Corporate Governance – Premise and Prospects*, New York, 2012, pp. 75 ff.; MERKT, *Internal and External Corporate Governance*, in FLECKNER - HOPT (eds.), *Comparative Corporate Governance: A Functional and International Analysis*, Cambridge University

have a broader responsibility than directors of non-bank corporates and internal governance serves exactly the purpose of helping them discharge that responsibility.

3. The European Commission has recently stated that «financial institutions' internal governance cannot be reduced to a simple problem of conflicts of interest between shareholders and the management» and thus governance rules «must be adapted to take account of the *specific nature of these companies*», in pursuit of the goal of enhancing the internal organizational measures [24].

Since the risk issues are seriously considered by policymakers[25], the peculiarity of banking activity is at the center of the regulatory setting. It is significant that CRD IV requires member States to «introduce principles and standards to ensure effective oversight by the management body, promote a sound risk culture at all levels of credit institutions and investment firms and enable competent authorities to monitor the adequacy of internal governance

---

Press, 2013, pp. 521 ff.; DAVIES - HOPT, *Corporate Boards in Europe – Accountability and Convergence*, in *American Journal of Comparative Law*, 2013, 61, 301; FERRARINI - FILIPPELLI, *Independent directors and controlling shareholders around the world*, in *ECGI Law Working Paper*, 2014, n. 258, 13.

[24] See EUROPEAN COMMISSION, *Green Paper on Corporate governance in financial institutions and remuneration policies*, June 2010; see also OECD, *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles*, February 2010.

[25] See HOPT, *Better Governance of Financial Institutions*, in *ECGI Law Working Paper*, 2013, n. 207, 11, noticed that «in the Basel Committee's eight principles for good governance of banks in 2006, the word "risk" does not appear at all, while in the fourteen principles of 2010 it appears in nine of the fourteen principles».

arrangements. Those principles and standards should apply taking into account the *nature, scale and complexity of institutions' activities*» (Recital 54; the same concept also is expressed by Recital 5 of MIFID II).

Two fundamental issues arise. First, banking activity makes directors' duty of care greater than in other businesses: the onus of responsibility is necessarily higher and more difficult to discharge, given the range and complexity of activities of most banks[26]. In the case of banking business, common directors' duties need to be fulfilled in accordance to the enriched set of risks they have to face, all along the decision-making chain: if generally in making business decisions the directors must act on an informed basis, banks' directors are obliged to gather wider and more frequently compiled sets of information in order to be aware of all the exposures and risks the bank faces and so to safeguard the proper and prudent management of the institution[27].

Secondly, the nature of banking business underpins the need for banking law to adopt a different approach or strategy from general corporate law to the extent the latter is not sufficient to protect all the public interest.

---

[26] See ADAMS - FERREIRA, *Regulatory Pressure and Bank Directors' Incentives to Attend Board Meetings*, in *ECGI Finance Working Paper*, 2008, n. 203; HOPT, *Trusteeship and Conflicts of Interest in Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society*, in Ferrarini, Hopt, Winter and Wymeersch, eds., *Reforming Company and Takeover Law in Europe*, Oxford, Oxford University Press, 2004, pp. 51 ff.

[27] In Italy, Cassazione February 5 2013, n. 2337, stated that bank directors have a greater duty of care than in non-financial firm as the diligence expected reflects the nature of banking activity. In discharging the duty to oversight, they must use all the organizational measures at their disposal, and in particular, non-executive directors cannot behave passively waiting to be informed by the executive ones, in particular because they can rely on the internal control system through which they could gather information about the action of the hired officers.

As a general principle, the decision-making process is supposed to reflect the nature of the undertaking's activity, as managers and directors' decisions determine the exposure to the risks arising from the specific business they are entrusted to govern. Accordingly, in banking institutions the complexities involved in identifying, assessing and monitoring the typical risks this kind of business faces set the bar very high for the conduct expected from those responsible for risk decisions: directors are required not only to pay more attention than in normal firms, as already mentioned, but also to be able to rely on well-defined organizational structures to assist with the decision-making process.

Thus, the complexity of banking business requires the implementation of a specific risk governance framework, which must satisfy the internal control needs, given that individual directors are realistically unable to handle all relevant issues by themselves without assistance that they can reasonable rely on.

Internal governance has caught policymakers' attention because it covers the set of internal rules, processes, procedures, structures and functions that are necessary to make the business work. It includes all standards and principles concerned with setting a firm's objectives, strategies, and risk tolerance and appetite, how its business is organized, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey.

In almost all jurisdictions, corporate law provides for directors to set up an internal structure, which is adequate to the nature and scale of the firm's activities, leaving to them the responsibility of working out the details of the

arrangement. Conversely, banking law predetermines *ex lege* the essentials the internal structure banks must establish, allowing less room for the directors' discretion in relation to such details, with much more prescriptive, and detailed, regulation[28].

A prominent example of this more intrusive approach requirements is the imposition of an internal control system as the main binding component of internal governance: if it is true that all corporations – included but not limited to banks – have an internal code or order (the internal governance), it is not always the case that all firms should be equipped with a control system framework, since this is in the discretion of directors. Since it is impractical to provide for a "one-size-fits-all" internal governance structure, corporate law does not generally specify what is required to constitute the organizational framework but instead requires directors to define it. Corporate law merely identifies in general terms the goal directors must pursue in performing their organizational duty.

As the aim of this general approach is provide for a wide range of circumstances, it could be argued that it should also apply to banks. However, banking law does not "run the risk" of directors being unable to properly manage the business.

Banking law cannot afford to risk giving directors the level of discretion that might apply to non-bank businesses because, with banking, the public interest is at stake. For this reason, it provides in more detailed provisions what

---

[28] On the relationship between the directors autonomy and the authority interference see also the next paragraph.

directors are required to do in order to establish the internal governance of the institution. The different approach that one finds in the case of banking law, as opposed to general corporate law does not mean the former derogates or is an exception to the latter. Banking law simply clarifies explicitly the content of a general principle, which in corporate law is addressed only implicitly.

In other words, one could say that, to some extent, financial law spells out what is generally a director's liability matter in order to protect market stability (or the public interest). Obviously, this does not imply that the regulator does the directors' job for them, but rather that it clarifies, into substantial rules, the specific application of a general principle in the case of banking business, making "visible" what is implicit in other contexts. Moreover, even if bank directors' duty to set up the internal governance appears quite restrictive, directors are nevertheless free to decide *how* to implement what the regulation requires, so as to preserve room for the inevitably differences within bank corporations and the consequent differing risk profiles that directors have to address.

Imposing the establishment of an internal control framework, banking regulation thus requires a mandatory organizational structure, which is chiefly preordained to improve the decision-making process, in line with the special functions and risks of banking, such as, e.g., credit, market, liquidity operational, concentration, reputational, compliance and strategic risk[29].

---

[29] See HAMALAINEN, *Mandatory Subordinated Debt and the Corporate Governance of Banks*, in *Corporate Governance: An International Review*, 2004, 1, pp. 93 ff.; LEVINE, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence*, in *World Bank Policy Research Working Paper*, 2004, n. 3404; MULLINEX, *The Corporate Governance of Banks*, in *Journal of*

Referring to EBA *Guidelines*, «the internal control framework of an institution should ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported, both internally and externally, and compliance with laws, regulations, supervisory requirements and the institution's internal rules and decisions. The internal control framework should cover the whole organization, including the activities of all business, support and control units. The internal control framework should be appropriate for an institution's business, with sound administrative and accounting procedures»[30].

Besides procedures, rules and other organizational devices, the internal control system includes specific independent control functions, such as a Risk Control function, a Compliance function and an Internal Audit function[31].

---

*Financial Regulation and Compliance*, 2006, 14, 375; LAEVEN – LEVINE, *Bank Governance, Regulation and Risk Taking*, in *Journal of Financial Economics*, 2009, 93, pp. 259 ff.; UNGUREANU, *Banks: Regulation and Corporate Governance Framework*, in *Corporate Ownership & Control*, 2008, 2, 449 ff.; MÜLBERT, *Corporate Governance of Banks after the Financial Crisis — Theory, Evidence, Reforms*, in *ECGI Law Working Paper*, 2009, n. 130; ID., *Corporate Governance of Banks*, in *European Business Organization Law Review*, 2009, 10, pp. 411 ff.; BECHT, *The Governance of Financil Institutions in Crisis*, in Grundmann *et al.* eds., *Festschrift für Klaus J. Hopt*, Berlin, 2010, II, pp. 1615 ff.

[30] See EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 24.2.

[31] As known, the internal control system is structured on a "three-lines-of-defence model": the primary responsibility for the identification, control, monitoring and mitigation of risk lies with operational areas across each business area; second line of defence is provided by Compliance Function and Risk Management Function; the last, third line of defence is the function performed by the Internal Audit which is responsible for providing independent review of the effectiveness of the whole risk management framework and adherence to processes in the first and second lines. The internal control functions should be independent of the business and support units they monitor and control as well as organizationally independent from each other, since they perform different functions (even if, pursuant to the proportional

In line with the general internal governance concept, internal control functions are specifically meant to support directly the management body and to help it be more aware of the level of risk exposure. An example is the reporting function required in cases where senior management undertakes greater risks than those anticipated planned in the strategy outlook[32].

As a key responsibility, the management body has to set and oversee the business strategy of the institution. In doing so, the management body is required to define the overall risk strategy and policy of the institution, including its risk tolerance and appetite and its risk management framework in order to plan how to behave and react in a variety of risk scenarios[33].

In addition, the management body should formalize the limits if the risks the bank is *a priori* prepared to take and the actual limits the institutions pursues, with a clear definition of what the strategic plans are (with the imposition of formalizing the business model) and which risks are implied by achieving them (obligation to implement a Risk appetite framework[34]).

---

principle, in less complex or smaller institutions, the tasks of the Risk Control and Compliance function may be combined). See, *e.g.,* LYONS, *Defending Our Stakeholders: Corporate Defence Management Explored*, in *The Business Continuity and Resiliency Journal*, 3, 2012.

[32] See FENG – LI - MCVAY, *Internal control and management guidance*, in *Journal of Accounting and Economics*, 2009, 48, pp. 190 ff.

[33] See EURPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 8.2; BASEL COMMITTEE ON BANKING SUPERVISION, *The internal audit function in banks*, June 2012.

[34] In Italy, the national supervisory authority (Bank of Italy) want the board of directors to formalize the "Risk Appetite Framework" (RAF), which has to contain of some parameters about the risk profile as to conduct properly the business having them constantly monitored. This reference framework expresses the following items: *i)* the maximum risk level a bank institution is technically able to face (risk capacity); *ii)* the risk level is supposed to be taken by the bank to achieve the predetermined strategies (risk appetite); *iii)* the maximum deviance from risk appetite to assure bank stability under the threshold of risk capacity

Compliance and Risk control functions are involved in providing relevant independent information, analyses and expert judgment on risk exposures, and advice on proposals and risk decisions made by the management body and business or support units as to whether they are consistent with the institution's risk tolerance/appetite. In particular, they are also required to recommend improvements to the risk management framework and options to remedy breaches of risk policies, procedures and limits.

In light of the above, it is clear that the internal control system is intended primarily to enhance the way the board of directors fulfils its duties, as it serves the scope of assisting the analysis of the risks directors are prepared to accept as appropriate for the business whilst at the same time fulfilling their supervisory task. The current legislative strategies on bank corporate governance are in fact more focused on the business activity features and on the best way to govern risks than on the traditional agency issues between managers and shareholders.

Since the main topic of current regulatory policy is the improvement of the decision-making process, emphasis should be no longer put on the conflicts of interest between shareholders and management (i.e. the classical agency problem) but on the conflict of interests between the board of directors and executives.

The agency issues between the management body (both as whole and as regards its individual non-executive members) and senior management could

---

(risk tolerance); *iv)* the risks actually taken (risk profile); *v)* the definition of operative boundaries consistent with the risks estimated (risk limits).

stem from the tendency of the latter to serve their own interests instead of the corporation's[35]. The relationship between the executive (who manages) and the non-executive (who monitors how the executive has worked) is becoming challenging – as in all agency situations in which agents delegate powers to principals[36] – due to the lack of information: «because evaluations and decisions are shaped by the information available to the decision maker, of the executives control the information the board receives, the board's monitoring and decision making functions often will be little more than nominal»[37].

Accordingly, the internal control system plays a role in eliminating the information imbalances amongst directors and senior management. If we read together two statements by the European Banking Authority, one saying that «the control functions should be established at an adequate hierarchical level and report directly to the management body», and the other one underlying that, «in assessing the efficiency of Internal Control within an institution, the management body should be able to rely on the work of control functions, including the Risk Control function, the Compliance function and the Internal

---

[35] See HOPT, *Better Governance of Financial Institutions*, in *ECGI Law Working Paper*, 2013, n. 207, 8.

[36] See JENSEN – MECKLING, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, in *Journal of Financial Economics*, 1976, 3, 5; FAMA – JENSON, *Separation of Ownership and Control*, in *Journal of Law and Economics*, 1983, pp. 301 ff.; ARROW, *The Economics of Agency*, in Pratt, Zeckhauser, eds., *Principals and Agents: The Structure of Business*, Harvard, 1985, pp. 37 ff.; DONALDSON - DAVIS, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, in *Australian Journal of Management*, 1991, 49 ff.; DEMSETZ, *The Economics of the Business Firms*, Cambridge, 1995, 15 ff.; HART, *Corporate Governance: some Theory and Implications*, in *The Economic Journal*, 1995, pp. 678 ff.

[37] See EISEMBERG, *The Board of Directors and Internal Control*, in *Cardozo Law Rev*, 1997, 19, 246; HILL, *Centro and the Monitoring Board - Legal Duties versus Aspirational Ideals in Corporate Governance*, in *UNSW Law Journal*, 2012, 35, pp. 341 ff.

Audit function»[38], it is clear that internal control measures, and particularly control functions, are meant to stay close to the management board. It is up to the latter to gather the information and obtain the elements it needs, firstly to plan the business strategies and the risk appetite and, secondly, to assess and verify how the entrusted officers and managers are doing, in relation to the agreed risk tolerance.

Internal control is not simply a warning system, which purports to save the management board from higher risk, but a complex set of requirements that results in processes to identify, measure or assess, monitor, mitigate and report on risks. Hence, internal control is "good" as long as it restricts harmful operations, but it becomes "bad" when it restricts useful ones[39]. This point is important as it is strictly related to the strategic plans and business long-term strategies the board has adopted. In this sense, cumbersome internal control systems tend to stifle innovation since innovation is always risky, even if the outcome could be opportunities that increase firm value[40].

In addition, the "nature" of the control activities performed by the internal functions reveals once again that they are conceived as a *staff* structure serving the management body. Unlike the role traditionally played by the Audit

---

[38] See EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 24.5.

[39] See STULZ, *Governance, Risk Management, and Risk-Taking in Banks*, in *ECGI Finance Working Paper*, 2014, n. 427.

[40] See KAPLAN - ANNETTE, *Managing Risks: A New Framework*, in *Harvard Business Review*, 2012.

Committee[41], the role of the internal control functions is principally to operate as a sort of advisor to the board, involving, for example, expressions of business judgment. Even if the final decision-maker is naturally the board of directors, internal control functions must pronounce on the merit of the business decision, as they possess the expertise required in order to deeply understand the risks undertaken[42]. This is why the head of the control functions should regularly attend board meetings.

In this regard, it has to be borne in mind that the internal control system, as a component of the internal governance measures, is a series of organizational mechanisms required to make the decision-making process run in an efficient and effective way. Consequently, the work of the internal control functions is mostly required to operate during the decision-making process (*ex ante* control) rather than at the time the decision has already been taken (*ex post* control)[43]. Therefore, internal control system aims at following step by step how business decisions are taken.

---

[41] See KRISHNAN, *Audit Committee Quality and Internal Control: An Empirical Analysis*, in *The Accounting Review*, 2005, 80, 649 ff.; DOYLE – GE - MCVAY, *Determinants of weaknesses in internal control over financial reporting*, in *Journal of Accounting and Economics*, 2007, 44, pp. 193 ff.

[42] For example, think about the Risk Control Function's role in strategy and decisions: the Risk Control Function (RCF) «shall be actively involved at an early stage in elaborating an institution's risk strategy and in all material risk management decisions. The RCF shall play a key role in ensuring the institution has effective risk management processes in place» (EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 26.1). «The RCF's involvement in the decision-making processes should ensure risk considerations are taken into account appropriately. However, accountability for the decisions taken should remain with the business and support units and ultimately the management body» (*Idem*, 26.5).

[43] For an analysis on the difference between *ex-ante* and *ex-post* control, see, e.g., PIË - RITSEMA, *Corporate strategy: Implementation and control*, in *European Management Journal*, 1993, 11, pp. 122

We should now turn to the theories underpinning bank governance. It can be argued that tensions naturally arise between non-executives and executive directors, reflecting the conflicts of interest between shareholders and managers. In the case of banks, such tensions and conflicts are made more complex by the additional public interest at stake in ensuring as far as possible that banks are managed responsibly.

4. As mentioned above, in pursuing the enhancement of the decision-making process, policymakers are increasingly interfering with internal corporate life of banks, mostly by setting up requirements for the organizational structure and by prescribing certain internal procedures[44]. An important strategy is redefining the organizational duty the board of directors has to perform, avoiding unfettered powers of decision.

Indeed, banking law grants less autonomy for implementing the internal organizational framework than corporate law generally does: while the latter usually provides the general duty of directors to set up the organizational

---

ff.; LEWIS, *Cause, consequence and control: towards a theoretical and practical model of operational risk*, in *Journal of Operations Management*, 2003, 21, pp. 205 ff.; DEKKER, *Control of inter-organizational relationships: evidence on appropriation concerns and coordination requirements*, in *Accounting, Organizations and Society*, 2004, 29, pp. 27 ff.; BELINFANTI, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, in *Stan. J.L. Bus. & Fin.*, 2009, 14, pp. 384 ff.

[44] See HOPT, *Better Governance of Financial Institutions*, in *ECGI Law Working Paper*, 2013, n. 207, 8; BELCREDI - ENRIQUES, *The European Corporate Governance Framework: Issues and Perspectives,* in *ECGI Law Working Paper*, 2013, n. 214, 20.

structure with a great margin of discretion[45], the former, on the contrary, defines the contents of internal governance.

Therefore, banks shall have «robust governance arrangements, which include a clear organizational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks they are or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management» (CRD IV, article 74 (1)). Accordingly, the management body «approves and periodically reviews the strategies and policies for taking up, managing, monitoring and mitigating the risks the institution is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle» (CRD IV, article 76 (1)).

The fact that regulatory norms explain the minimum content of the internal governance of banks notwithstanding the discretion of directors does not make the organizational responsibility more lenient than it otherwise might be. It is important to underline that banking law actually "takes over" not the province that remains to directors but the role in explaining what are the implications of banking business in this area, without displacing the professional duties of directors.

[45] For example, the article 2381 of the Italian Civil Code requires the directors to establish an organizational structure consistent with the nature and the dimension of the entrepreneurial activity,

Internal governance regulation policy aims at setting out *what* banks' organizational structure needs but not *how* to implement it. Thus, the regulations provide the structure to be applied in its essentials (using detailed prescriptions) without predetermining and imposing its implementation.

For example, banks are required to set up the internal control system, but the management body remains responsible for deciding how to put into practice the provisions under the trade-off costs/organization suitability to face the business risks. In other words, banks directors remain entitled of the power to set up the internal rules governing the corporation, even if they must abide by what banking law required being the organizational mechanisms and measure the same directors need to work properly.

Besides, it would be admittedly impossible to enact mandatory rules resulting in "one-size-fits-all" solutions, as it may lead to suboptimal outcomes[46]; moreover, it is necessary to preserve flexible margins to shape the structure in accordance to the specific risks to be faced[47]. An intrusive governance regulation is justified by the public interests at stake and hence policymaker are legitimated to enact a set of rules which quite often are more detailed than general rules applicable to " normal" firms.

---

[46] A too intrusive regulation, in fact, could lead to a "box-ticking conformity" or "cosmetic compliance" phenomenon: LAUFER, *Corporate Liability, Risk Shifting and the Paradox of Compliance*, in *Vanderbilt Law Review*, 1999, 52, pp. 1343 ff.; KRAWIEC, *Cosmetic Compliance and the Failure of Negotiated Governance*, in *Washington University Law Quarterly*, 2003, 81, 487 ff. See also *A review of Corporate Governance in UK Banks and other Financial Industry Entities*, London, 2009 (the "*Walker Review*"), in which it is stated that «*Governance practices are, by their nature, organic dynamic and behavioural rather than akin to black letter regulation*».

[47] See McCAHERY - VERMEULEN, *Six Components of Corporate Governance That Cannot be Ignored*, in *Tilburg Law School Legal Studies Research Paper Series*, 2014, n. 8.

In addition, it has to be highlighted that financial regulation is focusing on internal governance because the directors organizational duty is not an end to itself but actually it is instrumental to let the other fundamental directors' task to be properly performed, namely the monitoring one[48]. This legal strategy implies the intervention on the quality of decision-making process, which represents the measure of the way directors discharge their obligations[49].

The recent amendments on internal organization of banks therefore seem to be intended to stress the greater accountability of directors in

---

[48] See BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, October 2010, Principle 32: «The board should also ensure that the bank's organizational structure facilitates effective decision making and good governance. This should include ensuring that lines of responsibility and accountability-- which define clearly the key responsibilities and authorities of the board itself, as well as of senior management and those responsible for the control functions-- are set and enforced throughout the organization».

[49] See PAN, *A Board's Duty to Monitor*, in *NY Law School Law Review*, 2009, pp. 718 ff.; HILL - MCDONNEL, *Fiduciary Duties: The Emerging Jurisprudence*, in HILL - MCDONNEL (eds.), *Handbook on The Economics of Corporate Law*, 2012, pp. 144 ff.; *Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, Del. 2006*. See also *In re Caremark International Inc. Derivative Litigation, 698 A.2d 959, Del. Ch. 1996*; *South v. Baker, C.A. No. 7294-VCL, Del. Ch. 2012.*

A related important issue to be studied in the future is whether the *ex lege* imposition of a certain decision-making process affects the business judgment rule scope and, if yes, what are the consequences. As internal governance of bank regulation aims at improving the decision-making process minimizing the uncertainty and errors while directors are taking the business decision, the response to the question seem to be positive. Anyway, as already highlighted, «company boards are responsible for monitoring the effectiveness of internal control system but pleased against a legal obligation for boards to certify the effectiveness of internal control» (EUROPEAN CORPORATE GOVERNANCE FORUM, *Statement on Risk Management and Internal Control*, Brussels, 2006, par. 6), and . See also HANSEN, *The ALI Corporate Governance Project: of the Duty of Due Care and the Business Judgment Rule, a Commentary*, in *Business Lawyer*, 1986, n. 41, 1237 ff.; EISEMBERG, *Duty of Good Faith in Corporate Law*, in *Delaware Journal of Corporate Law*, 2006, 31, pp. 237 ff.; LANGEVOORT, *Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems*, in *Journal of Corporate Law*, 2006, vol. 31, pp. 943 ff.

discharging their duty of care and diligence: they are indeed expected to fulfil correctly their functions, as they are equipped *ex lege* with the organizational framework necessary to face up inherent business risks. Internal governance measures thus entail a more careful and aware conduct, since directors must exploit the works internal control functions, for example, are doing to their benefit.

In particular, it could be argued that the main internal governance support to the board is instrumental to pursue the goal of an informed action also in the perspective to prevent moral-hazard behaviours and to solve agency problems arising between the board of directors and the top management. In this outlook, it has been specified that «the benefits of an internal control system would be measured by (and largely limited to) how well it helps monitor and control the behaviour of the firm's senior managers»[50].

This consideration is based on the recent attention focused on the role of non-executive directors (NEDs), as NEDs tend to have less information within all directors: «the role of non-executive members of the management body within an institution should include constructively challenging the strategy of the institution and thereby contributing to its development, scrutinising the performance of management in achieving agreed objectives, satisfying themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible, scrutinising the design and implementation of the institution's remuneration policy and providing

[50] See LANGEVOORT, *Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems*, in *Journal of Corporate Law*, 2006, 31, p. 943.

objective views on resources, appointments and standards of conduct» (CRD IV, Recital 57).

In this sense, it is interesting to note, considering the broader view of the financial sector as a whole, that «management or supervisory body of the [insurance] undertaking has appropriate interaction with any committee it establishes as well as with senior management and with other key functions in the undertaking, proactively requesting information from them and challenging that information when necessary»[51]. In the same perspective, MIFID II obliges that «members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making» (see art. 9 (3)).

Monitoring responsibilities are not deemed to go so far as to require the NEDs to overrule the specialist directors in their field[52]. Nevertheless, if the monitoring duties are company-specific, banks' NEDs toned to obtain the specialized information needed to supervise the management, bearing in mind the high level of technical complexity that banking rends to involve.

To return to the initial arguments tackled in this work, since directors' responsibilities are necessarily related to nature of the business, the "special" duty of care provided in the banking sector could be considered as a sort of mirror-image of the banking specialty and, above all, of the kind of risks to be

---

[51] See EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY, *Guidelines on System of Governance*, 2013, Guideline 3.

[52] *Re Continental Assurance CO of London plc (in Liquidation)*, 2 BCLC 287, 2007. See BACHNER, *Wrongful Trading before the English High Court: Re Continental Assurance Company of London plc (Singer v. Beckett)*, in *European Business Organization Law Review*, 2004, p. 195.

managed. What policy-makers are seeking to create is a relationship between the financial sector's characteristics (in term of risks the financial institutions confront) and the directors' conduct (how they must perform their functions): the link is the internal governance, with particular reference to internal control system.

5. One of the most significant corporate weaknesses revealed by the financial crisis and related to the monitoring function performed by the management body was the fact that many board members were shown to be insufficiently qualified to know, understand, assess and handle the complexities and risks of banking activities[53].

In light of the critical role played by the board in the governance of banks, regulators have spent much more attention to the appropriate composition of the board. The result is a set of rules within CRD IV intended to intervene both on the composition of the board and on the skills the board members are required to possess, always pursuing the principal aim of strengthening the monitoring role of the board[54].

---

[53] An "half-way" measure between the organizational requirements intended to improve the decision-making process and the board composition is the creation of internal specialized committees within the board of directors: it is particularly increasing the regulation interest around the risk committee. Members of the risk committee shall have appropriate knowledge, skills and expertise to fully understand and monitor the risk strategy and the risk appetite of the institution (see CRD IV, article 76 (3)).

[54] See, *e.g.*, ENRIQUES - ZETZSCHE, *Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive*, in *ECGI Law Working Paper*, 2014, n. 249, 7.

Among other provisions on this matter, the Directive requires the board *as a whole* to reflect «broad range of experience» (art. 91 (1)) and to «possess adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main risks» (art. 91 (7)).

In addition, it is required that *individual* board members possess at all times «sufficient knowledge, skills and experience to perform their duties» (art. 91 (1)) and that they behave «with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management and decision-making» (art. 91 (8)). In achieving this outcome, banks have also to «devote adequate human and financial resources to the induction and training of member of the management body» (art. 91 (7)) and to foster diversity within boards (art. 91 (10), (11)).

The idea that the diversity should guarantee better performance thanks to members with general business experience and a specific industry knowledge as well is actually a *leitmotiv* of almost all the corporate governance codes, which are intended to complement corporate laws generally focused on the formal requirements for director qualifications without providing any indication about board composition[55]. Just to give an example, the German Corporate governance code recommends that the supervisory board has «knowledge, ability and expert experience to properly complete its tasks»[56].

---

[55] See EUROPEAN COMMISSION, *Green Paper*, *The EU corporate governance framework*, April 2011

[56] See GOVERNMENT COMMISSION, *German Corporate Governance Code*, May 2012, Recommendation 4.2.1. In the same direction, see also, *e.g.*, ASSOCIATION FRANÇAISE DE LA GESTION FINANCIÈRE, *Recommendations on corporate governance*, March 2011; BORSA

Different from general corporate laws, financial regulation requires that individual members of the board should have the necessary skills and expertise.

Although it has been correctly questioned, the effectiveness and the governance benefit of the mandatory diversity requirement[57], the pre-set combination of personal characteristics should not be considered and assessed by itself[58] but rather alongside the professional requirements the bank needs for its business objectives[59].

---

ITALIANA SPA, *Corporate Governance Code*, December 2011; COMISION NACIONAL DEL MERCADO DE VALORES, *Código Unificado de buen gobierno de las sociedades cotizadas*, JUBE 2013; FEDERAL MINISTRY OF FINANCE, *Austrian Corporate Governance Code*, July 2012.

[57] See in particular ENRIQUES - ZETZSCHE, *Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive*, in *ECGI Law Working Paper*, 2014, n. 249, pp. 8 - 11.

[58] Board diversity and its possible effects on board effectiveness, firm value and performance are still a controversial issue. See, *e.g.*, CARTER – SIMKINS - SIMPSON, *Corporate Governance, Board Diversity, and Firm Value*, in *The Financial Review*, 2003, 38, pp. 33 ff.; ADAMS - FERREIRA, *Women in the Boardroom and their Impact on Governance and Performance*, in *Journal of Financial Economics*, 2009, 94, PP. 291 ff.; AHERN - DITTMAR, *The Changing Role of the Board: The Impact of Firm Valuation of Mandated Female Board Representation*, in *The Quarterly Journal of Economics*, 2012, 127, pp. 137 ff.

[59] For a thorough presentation of skill-mix approach, see SCHWIZER – FARINA - STEFANELLI, *Dimension, Structure And Skill Mix In European Boards: Are They Converging Towards A Common Model Of Corporate Governance?*, in *Corporate Ownership and Control Journal*, 2010, pp. 87 ff.; MCCAHERY - VERMEULEN, *Understanding the Board of Directors after the Financial Crisis*, in *ECGI Law Working Paper*, 2013, n. 229. Within the behavioural corporate governance literature, see HUSE, *Renewing management and governance: new paradigms of governance?*, in *Journal of Management and Governance*, 2003, 7, pp. 211 ff.; DAILY – DALTON - CANNELLA, *Corporate governance: Decades of dialogue and data*, in *Academy of Management Review*, 2003, pp. 371 ff.; GABRIELSSON - HUSE, *Context, behaviour and evolution: Challenges in research on boards and governance*, in *International Studies of Management and Organization*, 2004, pp. 11 ff.; HUSE, *Accountability and creating accountability: A framework for exploring behavioural perspectives of corporate governance*, in *British*

As a matter of fact, the new provisions promote knowledge and diversity consistently with the special features of the financial firms, in terms of complexity and risks, as it is stated that the *adequate* knowledge is with reference of being able to understand the *institution's activity*. Therefore, the principle is that the board must be composed to provide for the appropriate skills and experience for managing the company and monitoring the top management[60].

Recital 60 of CRD IV explains that «the lack of monitoring by management bodies of management decisions is partly due to the phenomenon of "groupthink". This phenomenon is, *inter alia*, caused by a lack of diversity in the composition of management bodies». Actually, «more diverse management bodies should more effectively monitor management and therefore contribute to improved risk oversight and resilience of institutions. Therefore, diversity should be one of the criteria for the composition of management bodies». All the new provisions enacted on diversity are thus to be seen as a sort of backlash against the lack of oversight, as a more diverse board is expected to fulfil its monitor function better and more effectively. Therefore, board composition should be «sufficiently diverse as regards age, gender, geographical provenance and educational and professional background to present a variety of views and experiences».

---

*Journal of Management*, 2005, pp. 65 ff.; EES – GABRIELSSON - HUSE, *Toward a behavioural theory of boards and corporate governance*, in *Corporate Governance: An International Review*, 2009, p. 307

[60] It should be emphasized that the European Banking Authority shall issue guidelines on the «notion of diversity to be taken into account for the selection» of board members (see CRD IV, article 91 (11)).

To achieve the correct functioning of the board, in particular with regard to the supervisory task it has to perform, the CRD IV endorses an appropriate balanced board *vis-à-vis* its qualification of the members: even before establishing the balance of powers between executives, non-executives and independent members, it is of utmost importance to assess the balance of knowledge, judgment and experience to properly and consistently respond to the specific circumstances of each bank and define members' own duties as executive, non-executive or independent[61].

The same idea is at the base of the UK Corporate Governance Code, which requires a «balance of skills, experience, independence and knowledge of the company. The board must be sufficient in size to manage the business and board changes adequately and should include an appropriate combination of executives and non-executives directors (and, in particular, independent non-executives directors) such that no individual or small group of individuals can dominate the board's decision making»[62].

The regulation trends concerning board composition have therefore to be interpreted in light of the increasing importance of the nature of the banking activity. In fact, the recent rules are exactly preordained to have boardrooms,

---

[61] For instance, independent directors are used as a proxy for good monitoring by the board, but this monitoring depends on professional qualities and levels of engagement in board activities that are not necessarily captured by current definitions of independence: GORDON, *The rise of independent directors in the United States*, in *Stanford Law Review*, 2007, 59, pp. 1465 ff.; FERRARINI - UNGUREANU, *Economics, politics, and the international Principles for Sound Compensation Practices: An analysis of executive pay at European banks*, in *Vanderbilt Law Review*, 2011, 64, pp. 431 ff.; RINGE, *Independent Directors : After the Crisis*, in *European Business Organization Law Review*, 2013, 14, pp. 401 ff.

[62] See FINANCIAL REPORTING COUNCIL, *UK Corporate Governance Code*, London, Main Principle B.1.

which are fit for the risks to be assessed, thanks to a balanced set of skills and experience.

This is why the CRD IV requires to predetermine and formally identify which are the skills the bank needs to have: the problem is not the experience and professional qualifications of a director considered by themselves but these attributes in relation to the board as a whole and to what the decision making process needs to improve.

In the same direction, also the EBA has stated that «the management body should ensure that an institution has policies for selecting new members and re-appointing existing members. These policies should include the making of a description of the necessary competencies and skills to ensure sufficient expertise»[63]. In addition, «an institution should have a sound process in place to ensure that the management body members, individually and collectively, have sufficient qualifications»[64].

In this perspective, the requirement of formalizing and filling in a document scheduling which are the most adequate profiles for the complexity of financial firms is a way to formalize a "professional plan" consistent with a long-term strategic plan. This is extremely important for the purpose of developing a more risk-sensitive decision making process. As a matter of fact "diversity-means-risk-reduction" insofar diversity is intended as the obligatory combination of qualities related to the complexity of the business activity.

---

[63] See EBA, *Guidelines on Internal Governance*, September 2011, B.11.4.

[64] See EBA, *loc. ult. cit.*

The skills should be evidently improved in the future, «members of the management body shall be and remain qualified, including through training, for their positions. They shall have a clear understanding of the institution's governance arrangements and their role in them»[65].

By focusing on the nature of the risks each bank has to face, the alignment of the board composition with the corporate strategies reduces the pressure on the short termism[66] and constrain consequently excessive risk taking by the board.

6. It can be seen from the above that banks are faced with an extensive new generation of corporate governance regulatory requirements. They are directly geared to what many may feel are the "lessons learned" from the Crisis. As with all such backward-looking reforms, they may be open to criticisms that they do little more than "shut the barn door after the horse has bolted" or are focused on "fighting the last war". However, it is hard to see how policy makers could ignore the salient failures in governance, revealed all too often in reckless risk taking, that came to light as a result of the Crisis. If that results in "intrusive" regulations that come close to telling businessmen (at least those who run banks) what we might have thought common sense would have told them already, then so be it. Perhaps it has to be done.

There are, however, two caveats. The first is that there is a danger that excessive prescription reinforces the tendency amongst bankers to act as

---

[65] See EBA, *loc. ult. cit.*

[66] See VAN DER ELST, *Transparency of Directors' Attributes: Improving Proxy Materials in Europe*, in *Financial Law Institute Working Paper*, Gent University, 2013, p. 13.

though the “rule- book” is a comprehensive behaviour code and, as a result, take the view that anything that is not expressly forbidden is allowed and anything not expressly required can be ignored. The second is that the trust crisis is not addressed (and should not be expected to be addressed) by corporate governance reforms alone. Other approaches to behaviour and culture now need to be looked at as a matter of some urgency, not to displace corporate governance requirements but to sit alongside them. That is where the more interesting developments on “rules for running a bank” are likely to lie for the next few years. Assuming, of course, that the worst of the financial crisis is behind us!