PREFACE

On November 4, 2009, fifty-one prominent men and women from international financial institutions, major accounting and law firms, academia, media, and research and policy institutions, gathered at The University Club in New York City for a colloquium entitled “Governance of Financial Institutions.” The participants included twenty-one current or former regulatory officials, seventeen of whom have chaired or now chair government agencies that regulate financial institutions. The participants came from the United States, England, Germany, and France; several had significant experience with financial institutions in China and Japan. They met in plenary session and listened to moderated panels and presentations. They examined policies, approaches, and strategies aimed at improving the governance of financial institutions both in the United States and elsewhere.

The colloquium was conceived of by Roderick M. Hills, Partner, Hills Stern & Morley and former Chairman of the SEC, and cosponsored by the Institute of International Finance (IIF), the Hills Program on Governance at the Center for Strategic and International Studies, and The American Assembly of Columbia University.

The participants heard two formal addresses: one, on the eve of the colloquium by Paul A. Volcker, Chairman, President’s Economic Recovery Advisory Board; and another, during the colloquium, by Judge Richard Posner, U.S. Court of Appeals for the Seventh Circuit. The speakers were introduced by Richard D. Parsons, Chairman, Citigroup and Robert Denham, Partner, Monger, Tolles & Olson LLP, respectively.
The topics of the moderated panel discussions were:

- Board Structure and Accountability,
- Risk Management and Oversight,
- Executive Compensation, and
- The Role of Regulators, Authorities, and Investors in Shaping Corporate Governance in Financial Institutions.

The names of the moderators, panelists, and commentators as well as the specific issues that they addressed can be found at the end of this report.

We are grateful to each of our presenters for their valuable intellectual contribution and especially to the moderators, each of whom guided a discussion among the panelists, commentators, and participants, on which this report is based. It should be understood that this report is our best reflection of what was discussed at the meeting, and, while the meeting was intended to advance debate rather than come to specific conclusions or recommendations, it is our hope that the report will be the impetus for further discussion and study.

The text of this report, along with copies of the background reading, photographs of the colloquium, and other related material, is available on the web sites of the three cosponsoring organizations. The web addresses are listed on the back cover of this report.

The cosponsors wish to acknowledge IIF’s Rakhi Kumar, the Assembly’s Terry Roethlein, and the Hills Program’s Gerald Hyman, who were instrumental in the administration of the colloquium. They also are grateful to Maha Atal for her valuable assistance in the preparation of this report.

Neither The American Assembly, nor the Institute of International Finance, nor the Hills Program on Governance take a position on subjects presented here for public discussion. Comments by the panelists and participants were on a not-for-attribution basis. Participants spoke for themselves and not for the organizations with which they are affiliated. It should also be noted that the five current regulators who participated in the colloquium did so not in an official capacity but as individuals. Their participation should in no way be construed as an endorsement of this report or its findings.

The American Assembly, the Hills Program on Governance, and the Institute for International Finance wish to gratefully acknowledge the generous support of the sponsors of the colloquium: Deutsche Bank AG, HSBC, Ernst and Young, and Cleary, Gottlieb, Steen & Hamilton LLP.

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INTRODUCTION

“We are talking about the governance of financial institutions… into the future, and we are dealing with a situation in which the American people and peoples around the world have lost confidence in major financial institutions.”

— a colloquium participant

Now, nearly two years after the onset of the most spectacular financial crisis since the Great Depression, governments around the world seek both better regulation of financial institutions and greater global coordination among regulators, to prevent a relapse. Beneficial changes in regulation will no doubt yield beneficial outcomes. Nevertheless, the primary responsibility for the failure of financial institutions rests with their management and with boards of directors. In the future, boards of financial institutions must assume more responsibility and meet higher expectations. Given this enhanced role, the manner in which board members are selected and boards are structured need greater scrutiny. The roles of regulators, and investors in shaping governance of financial institutions must also be reexamined. In short, the directors of financial institutions must now respond to and manage new supervisory and investor demands, albeit within realistic expectations.
Examples of lax risk management and oversight leading up to the global financial crisis are manifold. Along with excessive executive compensation, these failures and shortcomings have created a crisis of confidence in the foundation of our financial system, undermining efforts to identify workable policies.

Even with the advantage of hindsight, there is no clear consensus on how to reform the regulation of financial institutions. However, one overarching sentiment courses through the colloquium’s discussion: boards of directors of financial institutions must take substantial steps to improve their oversight and thereby to restore confidence in the integrity of the financial system.

The participants in the November colloquium represented different backgrounds, perspectives, and interests and came together to discuss these challenges and the changes that must occur. They aimed to identify promising ideas and actionable policy recommendations. The participants acknowledged the size of the challenge, but they appeared confident that a restored and reinvigorated financial system can emerge.

BOARD STRUCTURE AND ACCOUNTABILITY

The assignment for the panel was to discuss the proper process for selecting directors of financial institutions, the qualifications needed for them, and the role of management and of shareholders in the selection process. Participants also discussed the optimal size of such boards and whether the positions of CEO and board chair should be split.

Participants fully understood that responsibility for the current financial crisis lies with many, including regulators, but they accepted that the boards of directors of many financial institutions deserve a significant part of the blame. As one speaker bluntly put it, “Boards of directors failed in their oversight responsibilities.”

Several participants made the point that, from a corporate governance perspective, the current financial crisis is fundamentally different from the scandals of the Enron and WorldCom era. This crisis, they argued, is not one arising from failures to act with the needed independence; rather, it is a crisis of competence:

It was a failure to . . . properly advise management by asking the right big questions at board level about liquidity and economic leverage. Boards also failed to distinguish the forest of franchise risk for an institution from the trees of day-to-day risk measurement.

THE ROLE OF A DIRECTOR

With the above observation in mind, speakers emphasized the need for directors to have special skills and experience. As a group, one speaker stated, “Directors should have the intellectual capacities and background to understand how the extremely complicated financial industry works.” Several others speakers stressed the need for board members to have continued special education and training: “There should be a tailored and structured induction program,” said one.

However, several participants expressed the view that many directors of financial institutions have not had the training and skills necessary for them to carry out their responsibilities.

One speaker argued strongly that directors of the largest financial institutions need to understand that apart from their responsibility to stockholders, they have an obligation to society, to our capitalistic system, and to avoid risks that
A speaker from Europe reported the prevalent practice whereby former CEOs of larger banks in Great Britain continued as non-executive chairs. In his view, the success of this practice suggests that competence is more important than independence. Another speaker noted, though, that this was a deviation from the norm in Great Britain of separating the chair and the CEO, and that British regulation requires “comply or explain” justification by firms that choose former CEOs as chairmen.

A former banker and regulator from the United States stated that this British model might not translate well to the United States. Whether it be a lead director or a board chair, he said, it is imperative that a person with such a leadership position on the board have complete independence from management.

A participant from Great Britain noted that the United Kingdom Combined Code provides for both a non-executive board chair and a “Senior Lead Director” who is responsible for evaluating the performance of the chair and who can be available to bring shareholders’ concerns to the board’s attention. Another speaker cautioned against the assumption that former CEOs will make effective non-executive chairs in the first place. A CEO’s experience as a forceful leader is not the ideal background for a non-executive chair, who needs to deal diplomatically with both the CEO and the independent directors.

Several participants expressed concern, too, about the effect that a non-executive chair could have on the authority of the chair of the nominating or governance committee and, to some degree, on the authority of other committee chairs. One participant noted that he had witnessed companies where the non-executive chair was more likely to protect the CEO from the independent directors than to protect the independence of the board.
Others worried about the tendency of a non-executive chair to erode the legitimate authority of the CEO. The title of board chair, said one participant, carries more apparent authority than that of lead director and, as such, presents a different consideration in organizing the board structure of a financial institution.

Several participants expressed the view that a non-executive chair should chair the nominating committee. This tethering, they said, would avoid conflicts between the two positions and provide some oversight of the chair by the other members of the nominating committee.

Many participants appeared to assume that nominating committees have significant governance responsibilities. One stated: “It’s the ability to decide what comes before the board as well as who is on the board that is so important for a financial institution.”

**SELECTION AND RETENTION OF DIRECTORS**

One participant stated that management’s role in selecting directors of a financial institution should be quite limited, a suggestion all attendees appeared to accept: “The CEO,” he said, “should not be the normal source of identifying potential candidates for the board.” “The first step,” said another participant, “is for the nominating committee to work with the other board members, including the CEO, to identify the knowledge, skills, and experience the board needs and the skills, knowledge, and experience it has [and to] identify the gaps and then prepare specifications for filling those gaps.” The resulting specification would be used, normally with external assistance, to seek qualified candidates.

Nominating committees, one participant said, “should work continually on the pipeline to renew the board,” so as to have candidates identified before they are needed. Others, who agreed that the CEO should not be the source of board candidates, nonetheless expressed the view that the CEO must certainly “have the opportunity to express his opinions” on final candidates. These speakers thought that other senior executives generally should not have a particular role in the selection of board members.

Participants further discussed the role shareholders should play in the selection and election of directors. There was considerable agreement that directors of financial institutions in particular should not serve if they do not receive a majority of votes cast at annual meetings.

There was little support, however, for giving shareholders a greater direct voice in the nomination of directors. The remarks of the keynote speaker, Paul Volcker, seemed to be the view of participants:

> I think yes, some stockholder activism may be useful but if it is too much and if it’s too easy you will get a lack of congeniality on the board that is destructive and not recognizing any common purpose of the organization. So I think you’ll see some change there; some stockholder votes may be useful on an advisory basis, but I myself don’t think you can go much beyond that.

A speaker noted that in Sweden the nomination task is given to a committee of the four or five largest stockholders but that this practice has recently come under scrutiny.

One participant suggested that nominating committees notify shareholders of the specifications being used to search for candidates and that they consider any
candidate suggested by a larger shareholder with the same diligence given to candidates selected by the committee.

Term limits for directors was a subject for extended discussion. All who spoke expressed the need to avoid a “frozen board.” One participant referenced a study which found that directors’ tenure at Bear Stearns and Lehman Brothers was more than double the tenure at other investment banks. Participants also noted that in the United Kingdom, regulators presume that a director loses independence after a certain period, and that some firms require review of board members’ tenure after two or three terms. There was, however, a reluctance to support prescriptive term limits in the fear it could deprive some boards of “some very good people.”

In contrast to director term limits, there was support for the proposition that a “process” be put into place by nominating committees to make certain that boards are regularly “refreshed with new members.”

**BOARD SIZE AND COMMITTEE STRUCTURE**

Participants also agreed with the keynote speaker’s comment regarding board size: “The smaller the board, the more an individual director is forced to feel that he has a personal responsibility for the organization.” Several participants suggested no board should have more than fifteen members.

Without much discussion participants assumed that boards of financial institutions should have an audit committee and, most assumed, a risk committee as well. Some, however, would combine the two and also combine the compensation and nominating/governance committees. Whether there should be a separate risk committee is discussed more broadly in the next section.

**RISK MANAGEMENT AND OVERSIGHT**

The panel’s assignment was to discuss how financial institutions have managed their risk exposures and to suggest ways in which risk exposure could be improved. In particular, the panel sought to describe how the Chief Risk Officer (CRO), the CEO, and the board of directors could best execute their roles in managing the firm’s risks.

There was widespread agreement among participants that the severity of the financial crisis has been seriously aggravated by lax oversight practices on the part of both the management and the directors of many, but not all, major financial institutions. However, several participants cautioned that better risk policies, better trained and authorized corporate risk officers, and more diligent directors may not be sufficient to prevent financial institutions from responding unwisely in the future to the same incentives that caused them to “maximize risk” in recent years.

These participants believed that too many institutions have lost sight of their central purpose and, as a result, have given too little attention to what businesses they want to be in.” In short, for many financial institutions, the business model is broken. One speaker put it this way:

Deregulation competition and technology have eroded margins, have lowered the return on equity, and...saturated markets in North America and Europe...and the response of shareholders and boards has been to...aggressively seek and concentrate risks.

Another speaker commented: “I think this whole notion of what financial institutions are meant to be doing has been lost, and they have been taken over...”
by too much focus on making money for the employees first, the shareholders second, and the clients and customers third.”

ROLE OF THE CRO

Panel members, speakers, and participants concurred in articulating the need for significant improvements in the monitoring and containment of risk at financial institutions. Most expressed emphatic support for a strong CRO, who reports directly to the CEO and to a risk committee of the board of directors. Many likened the CRO’s relationship with the board to that of the internal auditor; except that they equated the stature of the CRO with that of the Chief Financial Officer, if not higher. The CRO’s role was widely held to include both a strategic and a monitoring function, although participants differed somewhat in how much emphasis they placed on each function.

RISK GOVERNANCE

Several participants noted that the risks of financial institutions “are far more complex” than in other industries “because of the way that financial institutions relate to one another” and “the various markets in which they operate;” as well as the complexity of their products.

The complexities were thought to be so great that a panelist rhetorically asked “what can board members be expected to understand, because board members are generally generalists.” His view was that the CRO should meet separately with the risk committee and tell them “whether he or she believes that management is listening” to his or her advice.

This view was not unanimous. More than one participant took the position that a given institution’s need for a CRO or a risk committee should be decided on a case-by-case basis. Some consider the CEO, as the institution’s key strategist and decision maker, to be the party in charge of risk containment, and the CRO to be an integral part of management. One participant suggested, and some others accepted, that audit issues and risk issues could be dealt with in the same board committee. Those who held this view expressed concern about “over-compartmentalizing” the board.

The more prevalent view, however, was that monitoring risk and monitoring the audit in a financial institution are significantly different functions. One commentator said he “didn’t understand why people think that audit and risk go together.”

Another participant viewed the CRO as having an intrinsically adversarial position, outside of management, that carried with it the responsibility of challenging management’s assessment of risk. Others hoped for more collegiality between the CRO and management but agreed that the CRO must have regular executive sessions with the board’s risk committee to give his or her frank assessment of risk exposure.

A former chairman of a large non-U.S. financial institution stated that the CRO of a financial institution needs to be one of the “highest managers” and paid as such. Later he expressed support for the idea that the CRO should be second only to the CEO in stature and pay.

Several participants suggested that the board should have outside assistance to aid its oversight of risk. One spoke of using an outside source annually to analyze the institution’s risk controls, much like the external auditor examines internal financial controls. He also supported the use of an external expert to “benchmark” personnel involved with risk management to get “some external
In his keynote address on the evening before the colloquium, Paul Volcker challenged participants to deal with the enormous compensation awards that are enjoyed by top financial executives and are widely seen as unjustified. “It does seem to me to be out of hand, looked at from the outside,” he said. Though Mr. Volcker acknowledged the wide range of proposed guidelines for compensation policy, he noted that they “don’t say anything about the amount of compensation.”

He informed participants that “profits in the financial world . . . have risen to as much as 40% of all corporate profits in the United States.” Furthermore, he said, “If you added all the bonuses to the profits,” it could be “half, or more than half, of all the profits in the United States.” He questioned, “Does this great financial industry contribute fifty percent to the growth of the economy, to its innovation, to its productivity, to its sustainability…? Isn’t something really out of whack?”

**SEVERAL PARTICIPANTS SUGGESTED THAT THE BOARD SHOULD HAVE OUTSIDE ASSISTANCE TO AID ITS OVERSIGHT OF RISK.**

So while we can get lost in the question of how to define the risk of [an investment] and who within the bank is responsible for monitoring such things… we won’t come close to addressing the incentives that drive risk maximization until we deal with the purpose of the business and recognize the environment within which we are operating, “I don’t think,” he concluded, “that we have come close to addressing the incentives that drive risk maximization.”

**EXECUTIVE COMPENSATION**

The executive compensation panel’s assignment was to discuss how the board of a financial institution should set executive compensation, how to make compensation decisions that will discourage undue risk, and whether compensation policies should be subject to shareholder approval.

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**THE WIDE RANGE OF PROPOSED GUIDELINES FOR COMPENSATION POLICY... DON'T SAY ANYTHING ABOUT THE AMOUNT OF COMPENSATION.**

All participants who commented supported the use of clear and rigorous guidelines in fixing compensation policies for financial institutions. Strong endorsements were made of the principles set forth recently by the IIF and by the Conference Board. Both reports can be found on the websites of the organizations that sponsored the colloquium.

Commentators noted that such principles focus on discouraging employee remuneration on the basis of short-term returns while the firm takes the longer-term risks.

Participants suggested that compensation committees take the responsibility for the overall compensation policies of a financial institution, beyond payments to the top executives.
REGULATING EXECUTIVE COMPENSATION

Most participants assumed that compensation policies can be blamed, in significant part, for the financial crisis or for its severity. That assumption was sharply challenged by Judge Richard Posner in his luncheon address. He noted, as an example, that a Harvard professor assessed the “system of compensation at Merrill Lynch as ‘very good,’ with a lot of back-loaded compensation to control risk-taking,” but he noted, “Merrill Lynch tanked.”

He concluded his remarks: “So I think all the business about compensation is completely beside the point so far as avoiding future financial crises”. Participants did not respond directly to Judge Posner’s concluding remark. However, one observed:

Whether or not it’s true that compensation per se can control risk, it is certainly seen by regulators as a major issue in risk management and so, of course, the board of directors has to…oversee things in a way that will be seen as satisfactory to the regulators.

The discussion centered on the different approaches that are being proposed or that have been taken to regulate compensation policies. These included the standards endorsed by the G-20 at its Pittsburgh meeting in 2009, those proposed by the Federal Reserve Board of the United States, the Compensation Principles of the Financial Standards Board (FSB), and the Remuneration Code in the United Kingdom.

Participants noted that the G-20 proposals called for “substantial regulation of executive compensation” and that the United Kingdom was implementing these proposals with relatively precise rules while the Federal Reserve Board of the United States has only required firms to demonstrate that they have developed principles for compensation that are consistent with Federal Reserve principles.

The Federal Reserve delegated to the twenty-eight Large Complex Banking Organizations (LCBOs) the task of developing compensation standards that will protect the “safeness and soundness” of the institutions. This body will be required to come up with credible, firm-specific plans. As was observed by one speaker, a serious responsibility has been given the boards of financial institutions to develop effective measures and to report back to the Federal Reserve on their effectiveness. He did note there are no “caps” on pay in the Fed requirements.

Other speakers noted that the Remuneration Code of the United Kingdom, like the G-20 proposals, is somewhat more prescriptive of how compensation must be fixed. They characterized the code as rule-based as compared to the principles-based approach of the United States.

In commenting upon the UK Code, one speaker said it was designed to promote “effective risk management” by placing constraints on the board of major financial institutions in a key area of potential risk, namely the setting of compensation. Like the Federal Reserve Board principles, he noted, the UK Code does not cap compensation, although it does purport to establish ranges of compensation.

One speaker expressed concern that efforts to introduce restriction on compensation can be counterproductive and that earlier efforts had been ineffective. He noted particularly that “prescriptive rules that are uniformly adopted worldwide…increase systemic risk.” Another participant observed that “each of the 1990’s crashes followed an attempt to reform executive compensation.”

Most participants assumed that compensation policies can be blamed, in significant part, for the financial crisis or for its severity.
**REGULATORS EXPECT THAT THE BOARDS OF FINANCIAL INSTITUTIONS WILL EXERCISE MORE CONTROL OVER COMPENSATION POLICIES.**

Regardless of whether voluntary standards, the U.K. Code, or the principles of the Federal Reserve are to be the guide, it was clear to participants that regulators expect that the boards of financial institutions will exercise more control over compensation policies. One participant noted: “Financial institution boards are going to have to start thinking a lot differently about the kind of experience they want for people who go on the compensation committee.”

It is foreseeable, she observed, that at least one member of a compensation committee will need to be an “expert” in compensation policies just as it is now common for the audit committees to have at least one financial expert. Another speaker observed the need to have a close understanding between the risk committee and the compensation committee to meet “the challenge,” as put by a third speaker, “of linking appropriate compensation with appropriate risk management.” Another participant also anticipated that the use of independent outside consultants will likely result in annual “audits” of compensation policies.

One regulator emphasized that regardless of who the regulator may be, “Great emphasis is placed on the role of the remuneration committee to exercise much more thorough and extensive oversight and discipline... so that remuneration is much more closely aligned to effective risk management.” Another commented: “The regulatory imperative is becoming almost like another fiduciary duty” of directors.

Several participants expressed concern about the significant divergence between the regulatory policies on compensation between the United States and the United Kingdom. This gap, one participant said, “is going to move talent around.”

One participant urged the group to step up to Paul Volcker’s challenge to determine “how much is enough?” which is not easy to do. The ensuing discussion evidenced some discomfort with past compensation awards to financial executives and considerable concern about the likely public and political reaction to payout of the money already held in reserve by financial institutions for bonuses in 2009.

Overlaying the discussion was the observation that the growing profits now being recorded by financial institutions are, in large part, due to the trillions of dollars of stimulus and bailout funds being pumped into the economy by the United States and other governments. Further, one participant said that the failure of many firms and banks had lessened competition, which could also have helped increase profits.

The colloquium noted the possible danger of unwise regulatory action in response to large bonuses at year’s end. With most participants reluctant to suggest regulatory caps on compensation, one speaker’s answer was to rely upon “muscular board oversight.”

**ROLE OF REGULATORS, AUTHORITIES, AND INVESTORS IN SHAPING CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS**

The fourth session began with five speakers who have led or who now lead...
agencies that regulate financial institutions. Their views as to what reforms are needed in the board structure of financial institutions and in their risk management and compensation policies were generally consistent with those expressed in the first three sessions. The objective of the fourth session was to determine the extent to which participants believe reforms should be mandated by the governments.

PRIOR REGULATORY ACTIONS

Participants supported recent efforts of the Federal Reserve Board and the Office of the Comptroller of the Currency to establish more uniform rules and clearer expectations for financial-sector governance. They pointed particularly to rule-affecting governance changes at the board level that are aimed at increasing financial expertise of directors and at increased board oversight of risk management practices. One speaker applauded the new effort by the Federal Reserve Board to educate compliance committees in risk management practices.

Another opined that “the quality of many institutional boards has been enhanced” because regulatory agencies have insisted “that the directors of financial institutions have some financial level of qualification.”

However, one former chairman observed that “we regulators are, I think, too often given to sort of a process approach as opposed to substantive approaches.” He noted that while bank regulators had been paying more attention to board governance matters, in part because of the passage of Sarbanes-Oxley, those regulators have “no regulatory consensus” as to what makes boards work or risk governance effective. He also called for a greater “professionalization of regulatory bodies,” noting that the current system has “evolved by reason of history and not logic” resulting in “tremendous amounts of anomalies in the system” and “very little science.”

A specific complaint was that while audit committees adopt charters that spell out with some specificity their responsibilities, risk committees of boards have no charter at all.

While the participants supported more guidance from regulators, they resisted regulatory edicts. One speaker cautioned that “when the government issues its fiats in the form of legislation or regulation…people then devise checklists and they check off whether they are satisfying the requirements.” There was a danger that mandates would devolve into mere compliance, rather than better governance on a principled basis. Another commented “I do think that the Fed and the other regulatory agencies have got it right by setting guidelines first, as distinct from rigid prescriptions.”

In particular, a recent Federal Reserve proposal—with respect to compensation policies—was applauded because it is “principle-based.” As noted by a speaker, those principles are that the policies are “not to be used to promote excessive risk, that they are compatible with risk management and internal control procedures, and that they are supported by corporate governance and oversight by the board.”

INTERCONNECTED FINANCIAL INDUSTRY CALLS FOR GLOBAL GOVERNANCE AND UNIFORM REGULATION

A speaker highlighted the challenges that multinational financial institutions face in governance and, in a call for better “Global Governance,” he warned that “regulatory bodies have got to spend a good deal more time focusing on the complexity of international governance.” This struck him as particularly important with regard to the governance of multinational financial institutions outside their...
home countries. Host regulators naturally focus on the governance of entities under their jurisdiction, whereas international groups — and to some extent home regulators — look at governance as a whole, generally from the perspective of the parent entity. Participants accepted that coherent and consistent group governance, including well-integrated risk management, needs to be balanced with meeting the formal needs of local-entity governance and the expectations of host regulators for the management and governance of local entities.

Therefore, there was concern about the fact that in practice there is an enormous “disparity in national practices” in the regulation of banks.

Several supported a speaker who expressed concern that there is a “lack of thinking on what should be the architecture of the financial world.” “What we are seeing,” he continued, “is just regulatory bodies . . . rushing into solutions — quick fix — without . . . true coordination, despite what has been said in the G-20.” Another speaker expressed the view of a number of participants that there is a need for some “international regulation of financial services, because, you know, it is a global market.” But, he observed, “By the time we have serious international negotiations, we’ll have a lot of legislation in place and that will make it more difficult to have those negotiations.”

REGULATORY SHORTCOMINGS

At the outset, several speakers acknowledged that there had been significant regulatory shortcomings. As one speaker put it, the concerns with regulatory actions leading up to the crisis were:

First was the inability of regulators to keep up with changes in technology, which permitted all sorts of new instruments, new transactions, all executable within nanoseconds and government had no equivalent ability to understand it. The second was a fundamental lack of transparency. When you have new markets created, what we’ve seen is that even the people who created these markets had no comprehension of what it was that they were doing. The third problem . . . we had in government was that with all of these developments taking place, nobody had a clear understanding of who had the ability or the responsibility to deal with any of these things, and I think government lacked official tools.

Other concerns expressed about how the regulatory agencies dealt with corporate governance matters included the view that the quality of financial reports given to the directors of banks was often inadequate. Reference was also made to the October 2009 Senior Supervisory Group Report Risk Management Lessons from the Global Banking Crisis of 2008 that observed, “many firms’ information technology infrastructure is inadequate to monitor risk exposure accurately.”

Yet another speaker said it was “imperative that regulators should look much more broadly at whether the size, complexity, and business activities of some financial institutions are inherently risky and preclude effective corporate governance.” She believed that “until policymakers resolve issues such as these and appropriate responses are put in place, the efforts of corporate boards to assess and contain risk may be inadequate to protect financial institutions, their investors, and the . . . public.”
GETTING IT RIGHT

MANY PARTICIPANTS EXPRESSED CONCERN ABOUT THE CURRENT CONGRESSIONAL EFFORTS TO REFORM THE REGULATION OF FINANCIAL INSTITUTIONS.

Many participants expressed concern about the current congressional efforts to reform the regulation of financial institutions.

One speaker posed the following questions. “What are the chances that Congress will get it right when it redraws the rules?...Will the Fed actually use its new powers and will they use them in an effective way?...Will all reforms taken together actually reduce the chances of another meltdown?” Many participants expressed some degree of skepticism in the government’s ability to get it right in this round of reforms, with a speaker cautioning that “one of the first things that’s needed is for government to become more expert in a lot of these areas... before its sets requirements.”

A former chairman of a regulatory agency, speaking of congressional proposals to reform the governance of financial institutions, warned, “We have to not just worry that they don’t work but that they may actually go in the wrong direction.” He suggested that a Blue Ribbon Commission with private and public sector participants could “come up with a vastly better set of proposals to Congress than we’ve seen today.”

The idea of creating a new agency such as the consumer financial regulatory agency was opposed by several speakers and supported by none. One former regulatory chairman argued that we should be “cutting down the number of agencies.” Another agreed, saying, “You don’t need another set of complications...getting the alphabet soup down is the best thing we can do.”

That there is a serious need to have better-trained regulators was universally recognized. One former regulator stated that “professionalizing the supervisory bodies has got to be one of the highest priorities.” Another regulatory head said that he has “been a huge fan of professionalization of the regulatory bodies to a much greater degree than we’ve seen.”

Another former regulatory chairman suggested that a model for reforming the role of bank regulators and of CRO’s might be found in the experience that the Public Company Accounting Oversight Board (PCAOB) had in reforming the auditing profession. By creating an agency that could pay wages comparable to those in the private sector, talented auditors were able to substantially reform the external audits of publicly traded companies. His statement echoed that of a former regulatory head who earlier had said “the PCAOB is one excellent example...where Congress did create an agency with the firepower and the ability to recruit talent that...was equal to or roughly equal to the...people across the table, the sophistication across the table...and hopefully it...can happen again.”

Another warning note was sounded by a regulator who expressed his concern about legislative proposals that “assume one can solve all the problems by regulating the banking system, letting everything else alone.”

CONCLUSION

The colloquium did not seek agreement or consensus on the matters discussed. However, all seemed to accept the assertion that our current economic crisis was marked by a lack of competence. Much of the discussion centered
on how to create a competent board structure, competent risk management policies, and competent compensation policies. There was remarkable agreement about what those competent policies should be. The differences that were expressed are not substantial.

There was also a remarkable agreement as to what the role of government should be in creating the needed competence. While some in Europe wish to use rules and regulations that have some precision, the U.S. model appears to be one based on principles and guidance. However, both approaches seek comparable results.

Broad support was expressed for a greater “professionalization” of those who regulate financial institutions. Many expressed the view that such regulators are too likely to be “rule checkers” who are not asked or trained to use judgment in their work. Apt comparisons were made to the accounting scandals illustrated by the Enron and WorldCom scandals and to the fact that the PCAOB was created to retrain the auditing profession and increase the quality of the external audit.

It is noteworthy that several participants suggested that a PCAOB-type agency could be a useful tool in establishing greater professionalization of those who regulate or monitor financial institutions.

It is also important to emphasize the concern expressed about current congressional proposals to reform regulation of financial institutions by repeating the worry of a former regulatory chief that some proposals “may actually go in the wrong direction.”

While most participants did not register opposition to current proposals, several did suggest that care be taken before legislation is finalized: government [needs] to become more expert…before it sets requirements.

The principle reason advanced for a delay in regulatory reform efforts was a concern that actions taken in the United States would conflict with actions taken by other countries.

It is the hope of all who planned and participated in the colloquium that the discussion, as reported above, will stimulate further thought before major legislation affecting the financial institutions of the United States is enacted.
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Regulators participated at the colloquium as individuals, but take no stance on the report.

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APPENDIX

COLLOQUIUM ON THE GOVERNANCE OF FINANCIAL INSTITUTIONS
The University Club
New York, NY
November 3-4, 2009

November 3, 2009
RECEPTION AND DINNER
INTRODUCTION OF KEYNOTE SPEAKER
Richard D. Parsons
Chairman, Citigroup

KEYNOTE ADDRESS
Paul A. Volcker
Chairman
President’s Economic Recovery Advisory Board

November 4, 2009
COLLOQUIUM
Panel 1: BOARD STRUCTURE and ACCOUNTABILITY

MODERATOR
Kenneth W. Dam
Max Pam Professor Emeritus of American & Foreign Law, University of Chicago;
Former Deputy Secretary of the Treasury and Former Deputy Secretary of State
QUESTIONS FOR DISCUSSION

- What is the appropriate process for selecting and appointing directors to Boards of financial institutions? What role, if any, should the CEO or senior management have in the selection of candidates for Board membership?
- What is an ideal size for a financial institution Board and what committees should it have?
- What specific expertise, if any, should be required of financial institutions, particularly on committees? What priority should be put on diversity of directors in terms of experience? What are the trade-offs between such diversity and financial and risk management experience?
- What should be the size and composition of the nominating committee and how should members be selected?
- Should a shareholder with some minimum holdings be able to nominate directors?
- Is there merit in separating the chairman and CEO positions? Is a “lead-director” concept more appropriate? If so, how should the lead director be defined? Should functions of the role be specified, e.g. chairman of the nominations or compensation or risk committees?

QUESTIONS FOR DISCUSSION

- What should the relationship of the Chief Risk Officer (CRO) be to the Board and the CEO? What relative position should such an officer have in the organization? What steps, if any, should be taken to protect the independence of the office?
- What experience and qualifications are necessary for the CRO position and should they be prescribed by a regulatory body?
- What should the role of the Board be in setting and enforcing the firm’s risk appetite? Should the Board secure independent advice concerning risk?
- How closely involved should a Board committee be in overseeing risk management and the firm’s adherence to its risk appetite? What, if any, Board or committee approvals should be required for decisions with respect to valuation policies?
- How realistic is it to assume that a Board can intelligently influence the risk culture in firms?
**Panel 3: Executive Compensation**

- Should the Board seek independent assistance in monitoring the risk policies of a financial institution?
- What role should the internal audit function and the Audit Committee play in connection with risk assessment and valuation issues? What is the appropriate division of labor between Audit and Risk committees, assuming that there are both committees on the Board?

**Luncheon**

**INTRODUCTION OF KEYNOTE SPEAKER**

**Robert E. Denham**
Partner, Munger, Tolles & Olson LLP, and co-author of the Conference Board Task Force on Executive Compensation Report

**FORMAL ADDRESS**

**Judge Richard Posner**
U.S. Seventh Circuit Court of Appeals and Senior Lecturer, University of Chicago Law School

**Panel 4: Role of Regulators, Authorities, and Investors in Shaping Corporate Governance in Financial Institutions**

**MODERATORS**

**Roderick M. Hills**
Founder and Chairman, Hills Enterprise and former Chairman of the Securities and Exchange Commission

**Charles Dallara**
Managing Director, Institute of International Finance

**PERSPECTIVE**

**Eugene A. Ludwig**
Founder, Chairman, and CEO, Promontory Financial Group, LLC; Former U.S. Comptroller of the Currency

**QUESTIONS FOR DISCUSSION**

- How should the Board of a financial institution deal with the setting of senior executive compensation? What type of experience should be required to serve on a compensation committee; how should members be selected and what type of assistance should they have in exercising their responsibilities? Should some compensation policies be subject to a shareholder vote? What, if any, authority should a Board seek from shareholders on compensation policies?
- How can compensation committees avoid policies that encourage undue risk?
- What standards, such as the IIF Principles on Compensation, should a Board or compensation committee follow in performing their role? What international rules should be adopted? In addition to establishing and overseeing compensation policies and procedures, should Boards be involved in the firm’s choices with respect to conforming to international standards for composition and levels of base pay? Incentive compensation?
- How far down the leadership structure should the Board go in establishing compensation policies (e.g., for sales and trading and for risk and control personnel)?
SPEAKERS
Harvey Pitt
CEO, Kalorama Partners, LLC; Former Chairman, Securities and Exchange Commission

COMMENTS
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Retired Partner, Arnold & Porter, LLP; Former Chairperson, Commodities Futures Trading Commission and Member, Congressional Financial Crisis Inquiry Commission

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Vice Chairman, WL Ross & Co. LLC; Former Director, Federal Housing Finance Agency

Richard H. Neiman
Superintendent of Banks, New York State Banking Department

Terence Smith
Special Correspondent, The NewsHour

QUESTIONS FOR DISCUSSION

• From an international perspective, what regulatory oversight, if any, should there be of:
  – The qualifications and/or appointment of Board members of financial institutions?
  – The risk management policies of a financial institution?
  – The compensation policies and decisions of a financial institution?

• What authority, if any, should be given to shareholders to restrict the decision of the managers of financial institutions?

• Could an organization along the lines of the PCAOB, which was created to improve the auditing of publicly traded firms, improve the ability of management and regulators to better understand risk undertaken by financial institutions?

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The Institute of International Finance, Inc. (IIF), is the world’s only global association of financial institutions. Members include most of the world’s largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the Institute’s associate members are multinational corporations, trading companies, export credit agencies, and multilateral agencies. Today the Institute has more than 380 members headquartered in more than seventy countries.

The IIF mission is to support the financial industry in prudently managing risks, including sovereign risk; in developing best practices and standards; and in advocating regulatory, financial, and economic policies that are in the broad interest of our members and foster global financial stability. The IIF also supports education and training efforts of its members in priority areas.

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