TC Podcast:
Supervising Corporate Governance: Pushing the Boundaries

Speakers:

Paul Wright
Program Leader, Toronto Centre

Clive Briault
Chair of Toronto Centre's Banking Advisory Board

Host:

Demet Çanakçı
Program Director, Toronto Centre

Date:

January 31, 2021

Transcript:

Opening automation: You're listening to a Toronto Centre Podcast. Welcome. The goal of TC Podcasts is to spread the knowledge and accumulated experience of global leaders, experts, and world-renowned specialists in financial supervision and regulation. In each episode, we'll delve into some of today's most pressing issues, as it relates to financial supervision and regulation. The financial crisis, climate change, financial inclusion, fintech, and much more. Enjoy this episode.

Demet Çanakçı: Hello everyone. I'm Demet Çanakçı, Program Director at Toronto Centre. This podcast is based on a recent TC Note we published today. TC Notes are meant to provide practical guidance to financial sector supervisors on key supervisor challenges. I have two guests today, Clive Briault and Paul Wright, co-authors of the TC Note's titled, Supervising Corporate Governance: Pushing the Boundaries. Welcome Clive. Welcome Paul. Both Clive and Paul were senior supervisors in the UK for a number of years and have been long time program leaders with Toronto Centre. They have a huge amount of supervisor capacity building experience from working in emerging market economies. Clive is also the chair of the Toronto Centre's Banking Advisory Board, and the editor of the TC Notes series. Let's begin. There is a great deal of existing material about corporate governance, international and national standards that have written about it. And most supervisor buddies have standards as well. Does the world really need another paper on this subject? Perhaps we can start with you, Clive.

Clive Briault: Thanks Demet. That's a very good question, and you're certainly right. It is true that there is no shortage of standards and guidance in this area, in terms of both international standards, and in some countries, domestic codes, domestic rules, domestic guidance, and so on. But we think that we do need another paper on this subject. And in particular, a Toronto Centre Note aimed at helping supervisors assess corporate governance in the financial institutions they supervise, and to make supervisory interventions based on that assessment. Now, why do we think that? Well, because this continues to be an area that many supervisors clearly struggle with. And it was something that Paul and I have both observed on recent Toronto Centre programs that cover corporate governance. And we think this is, because although supervisors may be aware of the international standards, and aware of what makes for good corporate governance, they still seem to have some difficulty in assessing this, and in seeking improvements in the firms they supervise.

Now, this could be because they lack national standards for corporate governance in their own jurisdictions, which they may feel makes it harder for them to press for the necessary improvements in the financial institutions they supervise. It may be because in their countries, there is only a limited tradition of supervisors assessing corporate governance in financial institutions. So, there isn't really the internal knowledge of how to do that successfully, or there may be some cultural or political resistance to the idea that boards, particularly boards of financial institutions, should be open and accountable in their dealings with supervisors. So, for whatever reason, one thing we do observe is that some supervisors prefer to look at readily identifiable, easy to measure characteristics of good corporate governance, often using a fairly simple checklist for these.

So those characteristics might include whether or not the roles of a chair and the CEO are separated, whether there is a majority of independent non-executive directors on the board of a financial institution, various measures of gender and other forms of diversity in board membership and senior management, whether there's a set of board committees, especially for risk of internal audit, how often the board and board committees meet, and whether there are independent and seemingly well-resourced control and internal audit functions. But over time, financial institutions may gain any such list of characteristics. So, they make the minimum necessary changes to enable supervisors to tick the boxes and give these supervised firms a good score for corporate governance. And moreover, and more importantly, at the end of the day, what really matters for the quality and effectiveness of corporate governance is how well corporate governance operates in practice. How well it operates within the financial institution. So how well does the board challenge for senior management? How well does the board establish the strategy, values and culture of the financial institution?

How well does the chair of the board actually manage the board agenda and board meetings? How does a board identify and gain assurance that those risks are well controlled and managed? How does a board establish an operator company's remuneration policies? And how do control functions and internal audits really operate in practice? So, the main proposition in this Toronto Centre Note is that supervisors should be doing more to assess performance, and therefore the quality and effectiveness of corporate governance, not just a simple checklist of easily observable characteristics, and that they should do this in particular for the larger financial institutions they supervise. And in particular, where they are using a risk-based approach to supervision. So, this latest Toronto Center Note considers why supervisors may not have progressed beyond looking at the characteristics of good corporate governance. And it suggests some ways in which supervisors can move forward to an assessment of performance, quality, and effectiveness of corporate governance.

Demet Çanakçı: Thank you very much for this Clive. Paul, my next question is to you. Supervisors usually have quite extensive powers. So, if supervision of corporate governance is important, and falls short, why can't supervisors just do it?

Paul Wright: Well yes, that's another very good question, Demet. I mean, it's true, of course that supervisors do usually have quite extensive powers, but as Clive has indicated already, there may be a lot of institutional and cultural barriers to them making progress in this area, nonetheless. And starting with the senior managements of supervisory bodies themselves who may not fully grasp the importance of corporate governance, or in some cases, they may even be resistant to supervisors delving too deeply into this. And board may members in financial institutions may have very different views from supervisors about what boards are for, and what board members exist to do. And board members may also fail to understand why they need to communicate with supervisors at all, or to be accountable for what they do. It's not uncommon for board members to say to supervisors, "What's all this got to do with you? Why are you asking me about these things?" And these obstacles need to be overcome before supervisors can start pressing for higher standards, even if they do have formal powers. And the note looks at these kinds of impediments, and we offer some practical suggestions for overcoming them.

Demet Çanakçı: Thank you, Paul. Just to follow up on this. So, if it's possible to overcome these kinds of barriers, is it plain sailing for supervisors after that?

Paul Wright: Well, I mean, overcoming the barriers is an essential starting point, but in itself it's not enough. And to think about why, let's just go back a couple of steps and think about risk-based supervision. So, risk-based supervision goes way beyond the old idea that supervision's about checking compliance with rules and regulations. It focuses on existing and emerging risks in financial institutions, and crucially how well and effectively these are controlled and managed. And that focus remember is not just on risks today, but also on how these are likely to develop in future. And all of that means that supervision, risk-based supervision needs to be judgment-based. And making defensible judgements about corporate governance isn't easy.

First of all, supervisors need to have access to senior managements and boards, and to be credible, it's not possible to judge the effectiveness of boards unless you can see for yourself and hear for yourself how they operate. And supervisors need to be able to ask the right questions in the right way, and to interpret the answers correctly. And the note's got quite a lot to say about that, the most effective form of questioning and how to interpret the kinds of answers supervisors might get. And that's all pretty challenging. It makes supervision a lot more interesting and rewarding than a purely compliance-based approach, but supervisors need help, frankly, in getting to the point where they can feel confident in using their judgment. And again, the note offers some help here and advice.

Demet Çanakçı: Thanks, Paul. Back to you Clive, you have made several references to the practical advice in the note. Can you give some examples of that?

Clive Briault: Yes. Thanks for that Demet. The second half of the notes sets out a number of practical steps that supervisors can take. The first of these, as we see it may just be to put supervised firms and in particular, their boards of directors on notice that supervisors are going to take a closer interest in corporate governance. So, the first steps here could take a variety of forms, such as communicating to supervised firms an intention to look at corporate governance more closely, to begin generating more contact with boards and board members. And perhaps even suggesting that the supervisors might attend a board meeting to see what happens at those meetings. Another important step, which may provide a particularly fruitful way for supervisors to make a clear step into this area is that supervisors have found that they can make use of a crisis, or something like it, where something has gone wrong, either in a specific institution or more generally that emphasizes the importance of corporate governance and gives supervisors greater leverage in looking more closely at corporate governance and impressing for improvements to be made.

And that may be a crisis in your own country, or it may be a crisis elsewhere, but nevertheless illustrates this general point about the importance of corporate governance and the need to look at it closely in the way that Paul has mentioned. Another area we mentioned in the note, which again, may provide an avenue for supervisors to become more involved with corporate governance are new and emerging risks. So, for example, the COVID-19 pandemic, and the increasing emphasis now being placed by supervisors and indeed politicians and others on climate-related risks. In both cases, it should be reasonably straightforward for supervisors to contact a chair of the board of a financial institution and say we want to learn more about these areas, but one of the things we want to learn from is the way that you as a financial institution have been affected by these new and emerging risks. And to consider ways in which you, as a financial institution have responded to those risks through your risk management processes and procedures.

So, in that case, it's not a particularly threatening or intrusive approach to the financial institution. It's in part a way for the supervisorial authority itself to learn more about those new and emerging risks by discussing them with senior management and boards of the institutions they supervise. And as Paul said, we also set out some practical steps around the importance of supervisors asking the right sorts of questions, particularly to board members, having a framework for interpreting their answers, being resolute and bold in making evidence-based judgements based on what they've learned from discussing issues with senior management and board members. And perhaps most important of all, using those judgements to press for remediation when corporate governance falls short of the required standards.

Demet Çanakçı: Thank you very much, Clive, all sounds very interesting. Paul, you have the final say. Is this a foolproof recipe for supervisors to be able to get this right?

Paul Wright: Well, I don't think we would ever claim that what we write is foolproof, but more importantly, we hope that what we've written and the advice and the suggestions we've made, which are based on extensive experience will be helpful for supervisors who are trying to go further in this area. Standards of corporate governance have got a long way to go in many countries. And even in jurisdictions where we think of standards as being quite high today, that progress has often been made only in recent decades, and standards may still not be as high in many cases as we'd like. So, this is going to be quite a long haul, but corporate governance is so critically important, that any steps that supervisors can take on this tricky path will be very worthwhile.

Demet Çanakçı: Clive, Paul, thank you so much for taking the time to talk with us today. It has been a fascinating conversation. Thanks again for co-authoring this important TC Note, and many thanks for being such a strong supporter of Toronto Centre. I encourage participants to read the TC Note, which can be found in the resource center on our website. I'm here today with Clive Briault and Paul Wright, and you have been listening to another episode of TC Notes podcast series. Thank you for joining us today and stay tuned for the next episodes.