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Ten years on, risk remains a problem for banks

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- World marks 10th anniversary of collapse of Lehman Brothers
- Governance is crucial to manage risk cultures at banks
- Engagement program analyzes risk, including executive pay

A decade after the collapse of Lehman Brothers, Masja Zandbergen and Kenneth Robertson explain why governance is so crucial for the banking sector.

How time flies – last weekend the 10th anniversary of the start of the global financial crisis took place, when global markets plummeted after Lehman Brothers filed for Chapter 11 bankruptcy protection on 15 September 2008. Having gone through the Asian crisis and the dot.com bubble, this was not the first market crash I had experienced. However, the implications of this crash, which was the onset of one of the largest financial crises in living memory, were much wider-reaching. I would expect and hope that the financial community has learned from this experience… it has certainly affected the way we analyze the financial industry from an investment perspective. In this column, we will discuss our view on corporate governance in the financial sector, and why we engage with banks on ESG issues.

Far-reaching governance impacts

Aside from its immediate and far-reaching consequences, the crisis provoked serious discussion as to the role that poor corporate governance practices played in the crash. Ten years on from Lehman, board composition and the appropriateness of incentive structures remain a key focus of our voting approach.

The failure of boards to sufficiently understand and mitigate risks was seen as one contributing factor to the financial crisis, highlighting the strong financial materiality of poor corporate board oversight. Since then, the financial industry has undergone significant change. The assessment by policy makers across the globe that banks had been allowed the opportunity to take excessive risk led to significant changes in regulation, which have in turn affected corporate governance regimes at many major global financial institutions.

'The audit committee included a theater impresario'

Having the right skills in place

Understanding the quality of a company's corporate governance, and therefore its ability to understand and mitigate the key risks facing their organization, forms a critical part of our voting approach. In one way or another, many of the failures of the global financial crisis of 2008 could be in some way related to the nomination process of the companies concerned. For example, prior to filing for bankruptcy, the board of Lehman consisted of ten people, of whom nine were retired, four were over 75 years of age, and only two had experience in the financial industry. The audit committee included a theater impresario with no background in the fields of banking, risk management or audit. Clearly, this was not to be considered a case of best practice. So what, when reviewing the boards of today's banks, is?

We believe the role of the nomination policy is crucial to ensuring that risks are reduced by having the right skills mix, competencies and independence at both the supervisory and executive board level. Specifically, the transparent and considered approach of recommending directors to specific roles needs to be in place to manage these very issues. Using an appropriate and well-structured nomination process is therefore key in ensuring effective long-term risk management in the sector.

In our voting approach, we pay particular attention to the skills of nominees to the board's audit, risk and credit committees, to ensure that the composition of the board includes those with a deep understanding of risks, and how to mitigate them. In particular, we look for nominees with strong backgrounds within the sector and geography within which the companies operate, as well as outside experts with the knowledge to challenge prevailing assumptions about a company's risk appetite.

Independence is key

While the right skills are important, board members must also be able to raise their concerns as and when they see them. Board independence is therefore another aspect of corporate governance that is of particular importance in mitigating risk. Yet, many financial institutions, particularly in the US, continue to grant a dual mandate to their CEOs, allowing them also to sit as chairman of the board. To achieve effective management supervision, it is very important that the board can exercise independent judgment, and is free of conflicts of interest. It is of the upmost importance that the board is in a position to act as sparring partners for the management team, and that the CEO is accountable to a board composed of members who have an in-depth understanding of the business and the topics at hand, whilst also possessing sufficient independence to oppose senior management when things go wrong.

You get what you pay for

Still, managing risk involves more than simply taking a best practice approach to board composition. A plethora of examples exist where excessive risk-taking that is encouraged and incentivized by poorly constructed compensation plans has led to negative impacts on a company's (and particularly a bank's) bottom line. If companies over-incentivize excessive risk taking in the way they pay their senior management, excessive risk taking will in all likelihood take place. Many have argued that corporate remuneration structures have incentivized CEOs and top executives to take excessive risks, and played an important role in the significant losses incurred in 2008.

It is therefore a critical component of our voting approach to heavily scrutinize the executive pay plans of the companies in which we and our clients are invested. We focus our analysis on symmetrical alignment with investor interests, and on comprehensive disclosures by the remuneration committee about executive performance evaluation. Risk-adjusted metrics also play an important role.

Lessons learned?

Overall, we see that, on the whole, board composition practices have improved in the 10 years following the 2008 crisis. In particular, regulation has led to boards nominating more members with financial expertise than in previous years. Yet, it is still difficult to understand what goes on behind closed doors, and therefore to assess the quality of the board. In this regard, disclosure of board self-assessment results represents the next step forward for investors in understanding how risk is mitigated at board level.

Executive compensation also remains a key concern, in both our voting and engagement approach. The topic therefore plays a key role in our engagement theme: Risk Governance and Culture in the Banking Sector. This program aims to grasp how banks are setting their risk tolerances, implementing compliance and risk management systems, and managing their culture. Engagement on this topic is necessary because the quality of a company's risk management framework and the nature of its culture cannot be captured by only studying annual reports, risk statements and other company documents.

'Executive compensation also remains a key concern'

A tick-box approach to corporate governance is one thing, and while conflict-free boards and having the right KPIs in remuneration policies are important, the real issue of course lies in the culture. That's why, in our engagement approach, we look at a wider range of factors, including culture, how people are incentivized via non-financial criteria, and the tone from the top. People in the financial industry should realize that finance is not a goal in itself, but merely a tool to create socio-economic prosperity for all stakeholders.