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TAKEN BEFORE THE
PARLIAMENTARY COMMISSION ON BANKING STANDARDS
SUB COMMITTEE C
PANEL ON CORPORATE GOVERNANCE: BOARD LEVEL

TUESDAY 27 NOVEMBER 2012

PROFESSOR JULIAN FRANKS, DR PETER HAHN, DR TRACY LONG and STILPON
NESTOR

Evidence heard in Public

Questions 1 - 47

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Oral Evidence

Taken before the Parliamentary Commission on Banking Standards
Sub-Committee C—Panel on Corporate Governance: Board Level

on Tuesday 27 November 2012

Members present:

John Thurso (Chair)

Mr Pat McFadden

Lord McFall of Alcluith

Examination of Witnesses

Witnesses: **Professor Julian Franks**, London Business School, **Dr Peter Hahn**, CASS Business School, **Dr Tracy Long**, Boardroom Review, and **Stilpon Nestor**, Nestor Advisors, examined.

Q1 Chair: Good afternoon. Thank you all very much for coming in. Perhaps I could explain that we are a panel or sub-group of the Parliamentary Commission on Banking Standards. The various panels have been gathering evidence on particular topics, which we then formulate into a note that goes to the main Commission. What you say here will greatly assist us, and will be taken up by the main Commission in due course.

This panel is looking into corporate governance from the top-down perspective—that is, basically boards and how they function. We are working in parallel with another panel, which is looking at corporate governance bottom-up, as in how governance is run within companies. Our particular focus is on boards and how they function.

We would like to get out of this session a number of things around how the boards of banks in particular function, and have failed to function. One of the first questions is: are banks separate from ordinary plcs? Is there something about nationally significant financial institutions, as the banks are, that means that they need either different or more corporate governance? The second area we would like to explore is why and how did so many boards fail for the same reasons, when so many of the great and the good seemed to be on them? We want ultimately to ask you for any key recommendations that you might have.

We are hoping that another member of the panel will join us, but for the moment it is Pat McFadden and me. If we run out of questions, just keep going with the answers please. May I kick off by addressing the first point? Will each of you in turn say whether you think that banks are so complex and difficult as institutions for boards to deal with that we have to have a special construct, or whether in fact it is simply about doing what all big plcs do, and just getting it right. For the sake of good order, Professor Franks, may I start with you and work along?

Professor Franks: Can I be like a typical academic and say “no and yes”? They are not different from BP, Unilever or Shell. I would be just as apprehensive being a non-executive director of BP, Unilever or Shell as I would of being a non-exec of a bank. The “yes” is that these are all very complex institutions. I am sure if you asked a non-exec of BP about that, my

guess is that they would agree. What is different about banks is that they give rise to tremendous systemic risks. Whereas BP can destroy itself but the taxpayer does not bail the company out, it is the preponderance of leverage and the failure that gives rise to systemic risk that make banks different. It is those market failures that worry your Commission, and why you are not really so worried about BP or Shell. So that is the “no” and the “yes”. We should be worried about banks, but not because they are different from Shell and BP. They are very complex organisations, and I don’t think that non-executive directors can do the job that you would like them to do—

Q2 Chair: I shall come on to that, and my colleagues will as well. I want to go down the line, on the top line, as to whether these are just another PLC, however big and important, or something different.

Dr Hahn: I think they are fundamentally different in an extraordinary way. Generally, industrial companies have a business plan and products and they provide their service; essentially, what they are trying to do is to minimise the risks in those businesses. Banks, however, are fundamentally risk-management businesses; their business is to try to match risk and return on a daily basis. While, ultimately, I agree with what has just been said, the challenge is that it is very hard for many large businesses to change their risk profile very quickly, and a bank could take on unbelievable amounts of risk in a few moments.

Dr Long: From a board perspective, there are some similarities and there are some differences.

Q3 Chair: That is a yes and no answer, isn’t it?

Dr Long: Yes, they are very complex businesses, but actually there are other sectors that are also very complex. The reaction from a board perspective to the fact that it is very complex has been—it is now changing—that the boards have been very large. They have in fact been larger, in terms of numbers of directors, than other boards in other sectors, although that is now changing and their size is being reduced. Their levels of knowledge were perhaps not as great as one might have hoped for but, again, that has now changed, and there is much more knowledge about the business in the boardrooms of the banking sector than there used to be.

I guess another by-product of that—then I will stop—is that, because of the complexity and the number of people, it led them to split up the businesses into various committees. In one respect, that is a very good thing, a very good way of discussing the detail, but in another respect it leads to all sorts of dangers that not enough people are hearing all those conversations and being able to cross-reference. That is slightly different, but I would not say that it is in a completely different category from any other complex sector like pharma or oil and gas.

Stilpon Nestor: I benefit from being last and most of the important things having been told. I also agree that banks have some fundamental differences, as Dr Hahn said, but for me, from a board perspective, one important difference—maybe I will focus on that since it has not been mentioned—is that because they are systemic, you are much less tolerant of surprises in the banking sector, so it probably makes more sense to ensure some continuity, which brings me to an important norm that we are following according to the UK governance code: the chairman needs to be independent and not part of the institution at appointment. My personal opinion is that, in banks, this should not be the norm. The norm should be to appoint somebody who actually has a lot of familiarity with the institution, and maybe run the risk that there might be some sort of tension with the new CEO who is trying to change things.

The truth in banks is that you do not want abrupt change. Also, if I may say so, if one looks at the banks that failed or did badly during the crisis, most of them had chairmen that did not know their institutions—they were not themselves from the financial sector and, most important, definitely not from the institution itself.

Q4 Chair: Was it in your briefing or paper that you suggested that the old model of HSBC—of the chief executive moving up to chair—was a good idea?

Stilpon Nestor: Yes, I think it is a good idea, personally, for the banks. And in that sense they should be very different. If your question extends to whether we should have a different “comply or explain” benchmark my answer would be, in principle, no. The current framework that the UK has is flexible enough to accommodate these types of differences.

Q5 Chair: Can I come back with a second broad question? Can you identify in a reasonably short frame why so many boards failed to spot the problems that were coming down the track or, if they spotted them, why they failed to do anything about it? Why was there such a collective failure on the part of so many boards? What was the collective weakness? Peter, I will kick off with you this time and let Professor Franks have the last word.

Dr Hahn: The collective weakness was pointed out well in Sir David Walker’s review. Ultimately, it was a lack of banking risk knowledge on boards in various countries; it was not unique to the UK. He addressed that marginally, but I think that should be what we are talking about today: a lot more of the skill sets required on boards. The ultimate was—if I can go back for one minute. Historically the boards of directors of banks were made up of leading customers—the great and good, if you will—but they were almost a sight line on the economy, not necessarily a board to look at depth inside the institutions. That did not change as banks went from being minor, regional to global scale, so they kept up an almost amateurish approach at the board level and that caught up with banks everywhere.

Dr Long: Yes, a lot of the boards of directors in the banking sector missed what was happening. But they are not the only ones. There have been a lot of disasters—maybe more isolated ones—in other sectors, which boards of directors have also missed. One of the most important questions is, what can we and should we expect of our directors? How visible should they be and how much drilling down into an organisation should we expect them to do? To a certain extent, there is some realism and some unrealism about that.

Part of it is also to do with culture. These big, complicated, complex organisations—it is hard from the boardroom to see right down into an organisation and see how people are behaving. In the end, this comes down to human behaviour and human incentivisation. Although boards of directors have visibility of some of that, they do not have visibility of all of that. One just has to think carefully about how much we want them to have and how much time, realistically, we can expect them to spend looking at that.

Q6 Chair: Is there a danger that—particularly sitting in rooms like these, when we have been grilling bankers; we have had, particularly, non-executives in front of us—we expect them to be something they were never intended to be?

Dr Long: Yes.

Q7 Chair: And actually the key point about a non-executive is they are not there to second-guess the management; they are there to ensure that management is doing what it is supposed to do. That is a point that we all need to grasp.

Dr Long: I think the answer to that is yes. That has changed already, in that, as many of us have already noted, the level of collective knowledge about the business itself, which we would all expect the boards of directors to have, has already increased. There are already more people operating in financial service sector boardrooms who know what the business does. Maybe that was not true a few years ago, but it is true now. One does have to think about where the line is between independent and non-independent or executive and non-executive. When does somebody stop being completely objective and having a pair of fresh eyes on something because they have become too much part of an institution?

Chair: We will come back to that.

Stilpon Nestor: First, I agree with everything that Tracy has said, but I want to add another perspective on failure. Part of the failure was the fact that boards were expected, because of the very detailed regulatory framework that the banks have had since the introduction of Basel II, to look at the bank from a very specific vantage point, at least when it comes to risk. They were all very religiously following regulatory indicators of the bank's risk profile and soundness. They did not dare and nobody expected them to, including the regulators, get out of this box.

It is interesting to see the difference between gross leverage and tier 1 capital. Tier 1 capital stayed basically stable from 2003 to 2008, but in many of the institutions that we are talking about the gross leverage exploded to something like times 60, which had never been seen before—"Jamais vu", as the French say.

Q8 Chair: You are back to Andy Haldane's frisbee and the dog.

Stilpon Nestor: I very much agree with Andy Haldane's perspective on regulation, but I want to underline the effect that this perspective has on governance. It tends to put people in a box and if there is any value to any board, it is that it is the only instance when people around the table are outside the box—they are not part of the institution.

Q9 Chair: You referred in your paper to the elephants in the room, and that resonated with me hugely. What you are really saying—so far collectively, and we will come on to personally—is that one of the biggest problems is getting out of the "groupthink" that being collegiate requires of everybody and much more into a culture of challenge, so that people can say, "What about this, that or the other?"

Stilpon Nestor: It is difficult to challenge a view when it comes with the imprimatur of the regulator. It makes it twice as difficult, if not more. That is the problem. We are asking people to challenge something that is the orthodoxy. We are asking them to become Martin Luther.

Professor Franks: I think I agree with everything that my colleagues have said. The failure was not just a collective failure of boards, but a collective failure of regulators and of market analysts, including rating agencies. It would be so easy if it had just been boards that had failed. You could have said, "Well, that must mean something is really wrong." What was wrong with regulators? What was wrong with market analysts, who failed to spot this, and rating agencies? This is a bigger collective failure.

Why do I think that failure occurred? First, there have been three failures in banks in recent years, and that adds to the complexity point. There was the systemic crisis, mis-selling and LIBOR. It is not just one problem. That adds to my view that banks are complex and if you think that you can fix boards to fix these problems, that is a great mistake. You need structural changes. We can improve boards, but do not lay too much emphasis on that as a way of stopping the problem.

Q10 Chair: To be clear, where we are working from as a Commission is that there is a whole range of things that needs to be looked at. We are concentrating on this aspect of boards as one of a series of work threads.

Professor Franks: Can I point out one or two things that I think boards focused on? As colleagues have said, maybe a few per cent. of a bank's capital is financed by equity. What metric did banks use? Return on equity. I think that this is a pernicious metric. Very few industries focus on return on equity. The only ones that do so are shipping, real estate and banks; there may be one or two others. What is the common denominator? Incredibly highly leveraged transactions. It is most inappropriate for an institution financed by debt and financed by taxpayers' guarantees to focus on the return on this sliver of capital.

I think that the crisis was made worse by the fact that banks do not have large owners; they have dispersed owners. The largest owner or the largest shareholder of HSBC is probably Legal and General, or something like that, with 5%. If you have 1% of HSBC, you are a major shareholder. Where was the monitoring, and what was the role of the market in monitoring? That is what I mean by collective failure. The collective failure was among owners, as well as by regulators and boards.

Q11 Chair: If you define success as return on equity and you remunerate accordingly, you are reinforcing the wrong message all the way down the line—the incentives are completely out of kilter.

Professor Franks: I think you are. As a board member, you ask, "What's the cost of debt?"—very low—"So why should we raise equity when the cost of debt is so low and we can arbitrage that difference from the return on debt?" Of course, the reason why you can borrow so cheaply is that the taxpayer has provided you with this guarantee. If there was a serious board failure, it was to fail to realise that the low cost of finance did not reflect the underlying risks; it reflected that Government guarantee. That was a serious failure.

Q12 Chair: The reason why I am asking this question—I shall hand over to Pat in a moment—is I have done a little study of Hoare's Bank, because I was interested by it. In many ways, it is a leftover from a previous time: it has strict liability. I looked up its balance sheet, which is relatively small—way below the £25 million ring-fence cap. The fascinating thing is that there are still seven, I think, members of the family who are the equity holders, with unlimited liability. They meet weekly or whatever it is, in a meeting of partners, which is effectively what they are.

I will bet you—this bit I could not google—that when they sat down, they were saying to themselves, "What could cost us our livelihoods?" That is the first question, and "How much money can we make?" was way down the tree. When the big plcs, with limited liability and highly paid managers, were sitting down, I bet the first question was, "How do we make a lot of money?" and "What is the possibility of losing everything?" was way down the tree. I am interested in whether there is any way in which we can reverse those attitudes for the big companies.

Professor Franks: There are two things you could do with banks in terms of boards and monitoring. You could make it a very explicit fiduciary duty of bank boards to be responsible not just to shareholders, but to depositors and Government as the supplier of a guarantee. I am a trustee of a pension fund, and I am very well aware of a much broader fiduciary duty to existing pensioners, to those who are still working and, indeed, to the company financing the pension fund. A more explicit fiduciary duty would move away from return on equity,

because once you have a fiduciary duty to depositors and Government, you are looking at return on assets.

There is a fascinating study by Knight Vinke, which held 1% of HSBC. It looked at 54 banks and found that, in terms of the cost of capital, banks were not making their cost of capital. They looked as though they were doing very well on return on equity, but they were failing to make an adequate return on their whole capital. This fiduciary duty would be helpful.

I wonder whether we can rely on shareholders, who constitute a sliver of capital, and whether we should not strengthen debt holder activism, but I am now moving to solutions.

Q13 Chair: I am sorry, I am going to throw this across. You and I are having a fascinating, almost private, conversation. It strikes me that there is a real problem with the Walker and Kay approach, of saying, “What we need to do is get the shareholders involved lots more”, for the very reason that you identified—the vast majority of large shareholders have less than 1%. This is not like an AIM company where five shareholders will own 75% and can act like owners. This is just a commodity called their stocks and shares.

Therefore, to say, “Let’s get them all involved”, really just adds complexity almost rather than providing any form of solution. I put this to you as a proposition: what one really has to try to do is look to the non-executives to act as if they were the owners and to take that stewardship on board as a primary task, much more than in companies where those owners are able to do that for themselves.

Professor Franks: I am afraid to say that, if that model would work, we would not need owners and we would not need capital markets. I do not think directors can substitute for ownership. If they could, capital markets would have very little role. Forgive me, but I think we have to look for structural solutions. That does not mean that we should not try to improve the governance of banks. There are lots of things that we can do but we have to have the structural changes as our main defence against systemic risk.

Q14 Chair: I am going to open that conversation up to the other three.

Dr Hahn: If we look at what happened in the crisis, there was a consensus between regulators, Governments and shareholders, that for large financial institutions shareholders did not know what was going on and couldn’t exercise governance. Why? Fragmented shareholders and those in a mostly passive investment world—index funds only are the major shareholders in banks. Many of the tasks that are bread and butter to a typical board of directors—choosing new chief executives, approving mergers, dividends, even bonus pools—are now subject to regulation. It is not just in the UK; it is EU-wide and the USA.

There has been a broad acceptance of the fact that shareholders are incapable of understanding what goes on in a complex financial institution. The question always goes to the board, trying to understand what the board should know, could know and what our expectations are of the board. Ultimately, there is a much bigger question, and that is the Andy Haldane question you raised about simpler regulation. Certainly some avenues: yes or no. Realistically, the only institution that can understand the risk that is being undertaken by a bank is its regulator. The regulator gets substantial inside information; it knows a lot more than the market place. The only one that can judge whether a board is monitoring the risks inside an institution is the regulator. We need to figure out in structure how a modern board works with regulation and with shareholder interest.

Dr Long: On a practical note, there are one or two things to say. In terms of shareholder engagement, it is not for lack of trying. Most chairmen, most senior independent directors and

most remuneration committee chairmen have tried and tried and tried to see their shareholders. Very often their shareholders show no interest whatsoever in seeing them until there is a problem, and then they will see them. It is true that shareholders have been a little more active recently, but it is only recently.

Secondly, I think directors do take into account their stakeholders. That is what company law is all about now. It is not just about shareholders; it is about stakeholders generally. It is about employees, customers, distributors, regulators. Certainly from the work that I do, I see that boards are desperately trying to talk about all of these constituencies and get to know as much as they can about all of them when they meet. But there are a lot of them and there are different levels of knowledge about each of them. I would say that what they know about customers is perhaps a little bit lower than what they know about their shareholders. They are perhaps even closer to shareholders than they are to, for example, their customers, and that may be something that can definitely be improved in the future. If one wants boards of directors to think and act more responsibly towards all their stakeholders, one then has to look back into remuneration and say, “What is it we are rewarding our executives for achieving within this organisation? Are we rewarding the right things? Do we all understand how these people are being rewarded, what they are being rewarded for and what the unintended consequences of these rewards might be?” That is very complicated.

Stilpon Nestor: Again, I am the last one, and I am benefiting from that, which is great.

On the points that were made, I fully agree with a more focused approach on the actual level of liability and the interpretation of the duty of care and loyalty to the company, because, in legal terms, that is where it is. It is not a fiduciary duty, as the Americans would put it, to the shareholders. Banks could do with an approach that is more focused. That actually differs from that of other companies in the sense that it has sanctions if the institution fails. Part of your care and loyalty is also the long-term solvency of the institution, which is not there in other companies and rightly so, because sometimes when you take risk, you fail. That is one point.

A second point is to do with the role of non-executive directors. I am not sure that I would agree that non-executive directors should act as shareholders or that, for that matter, anybody should act as shareholders in an institution where shareholders benefit so much from leverage. One of the observations from the American banks, at least, that failed miserably—Lehman Brothers and Bear Stearns before that and others—is the amount of long-term alignment between the people who were running these institutions and shareholders. These were the long-term shareholders of the banks that failed. It is not because they did not have a shareholder perspective that the banks failed. I tend to believe that it was the opposite. It is because they had too much of a shareholder perspective that these banks failed.

A third point is about what we see today in Europe about the banks that perform better. This is interesting, because the best-performing banks in Europe—we tried in our study of the 25 largest banks actually to couch that in the most general and inclusive terms—are the Swedish banks and the Spanish banks. Both are banks that are closely controlled by very strong owners. I am talking about the top two banks in Spain—Santander and BBVA—not the whole universe of Spanish banks. In the Spanish banks, control is informal. These are people who used to have the ownership power in previous times, and they have retained it even though they are now not major shareholders. In Sweden, it is done in more explicit ways by having multiple voting rights and actually having a controlling shareholder that looks at the adequacy of the board in a very focused way, since they have moved the nomination function from the board to the shareholders. This might be an approach worth considering if we believe that shareholders should be playing an important monitoring role. Otherwise, the incentives are such that I think it is a waste of time trying.

Q15 Mr McFadden: Just a word on job description, before I ask you some questions. This point about collective failure that you made, Professor Franks, is right. We had Bill Winters in front of the Treasury Committee last week, and he talked about a “collective screw up”, which I think is a fair description. However, if we think that because a lot of people did not see this coming, nothing can be done, that would be a mistake. It would be a counsel of despair, so the task for a Commission like ours is to see what we ought to recommend and also to bear in mind the grave danger in exercises such as this, which is to equip yourself perfectly to fight the last war rather than the next. That is my thought on job description, as we approach this. As John Thurso said, this is one panel of many that are looking at things like SME and consumer lending, wholesale finance and a number of other issues, so we are not focused solely on this. That is where it fits in to the overall work. In fact, in the full Commission, we have spent the last month in a quasi-theological discussion of ring-fencing, separation, and where all that should go.

I want to take you through some questions about size, organisation, personnel and so on. Not everybody has to respond to each question, but let us begin with size and structure. We have two models that we think about—the unitary board model, and the dual board model with a supervisory board above. If I could just kick off on the strengths and weaknesses of that, we in this country tend to think of the UK model as being more the unitary board. Are there any specific weaknesses or strengths of that, or does the question of unitary or dual boards not really matter? Dr Hahn, do you want to start?

Dr Hahn: My view would be, first, that the issue of size is challenging; it depends on the institution. If it was just about size, Northern Rock and Bradford and Bingley would probably be our leading banks today, because they had smaller boards than the bigger banks. It depends on the functions of the bank and how an organisation is run, but in terms of the unitary board concept, we do not really have unitary boards and we haven’t for a long time. We have what looks like a unitary board, which is a group of executives who spend 200-plus days a year in the organisation, and this other group that comes in one or two days a month—sometimes a little more—who do not have the same level of information by any stretch of the imagination. They meet together. The concept often gets confused—you told me that there is a German model, where it is top and bottom, and it is outside. But I think that is part of the failing, and it is a question of what knowledge base that non-executive group should have, what we want of them, and where they get their information from. There are many other questions that are related.

On the inside group, to give you an example, I advise a large Government organisation for 50 days a year, more or less, and I am inside that organisation. I know a lot about it, but I know what I am really focused on inside it. I do not know a lot about the rest of it, and that is a limitation that we have to think about in a bank, because as you have noted before, the governance aspects of a bank are not as simple as they are in many industrial companies. They go downward and if you even think about the lowest level of information flowing up to boards, the individual making a loan in a bank, whose loan is approved at three or four levels up, has enormous incentives—not necessarily bonus incentives—when that does not go right to not communicate that information up the line. They would rather wait and see if it works out, so the level at the top has to understand the unique governance issues in a bank. They are not the same in other businesses. I almost wonder whether people coming from industrial companies can ever really understand the governance requirements of a financial institution.

That should be a big issue, because when we start to think about the concept of the size of boards, it is not necessarily that some banks have very large boards. It is what we expect of the people on those boards. Some of those people are trying to do a good job monitoring the

risks and working with management on the risks. A number of people on some of the larger boards are really there for big picture advisory work. I wonder whether we do not solve the big board question by moving some of those directors who have more of an advisory function into an advisory board that does not necessarily meet as frequently as the core board.

Q16 Mr McFadden: Your answer is really about information disparities, and we should not focus too much on this German thing of dual boards or the size of a board and so on. What about you, Dr Long?

Dr Long: I am a big fan of the unitary board structure. I have conducted almost 100 evaluations over the last nine years, and when the unitary board structure works well, it works extremely well. There is nothing to beat it across Europe or in the States. It does not always work well, but that is not because it is a unitary board structure. As Peter and, I think, Julian said, there are very many different kinds of directors making up a unitary board and they are all giving different amounts of time. What has worried me in review is the number of people involved. Certainly, in the banking sector, there have been more of them. The justification for that used to be that it is a very complex business, so obviously one needed enough people to understand it. If it was international, then one needed people who represented different parts of the world because they understood the customer experience from that part of the world. Then there is IT, customers in the UK and so on. There are different areas that people suddenly start to think that they need to represent. That has changed. Now the most important thing is knowledge of the business, which is how it is in other sectors, too. One thing that has concerned me more is the committee structure. Financial services tend to have more committees. They now have a risk committee, so they have audit, risk, remuneration and nominations.

Q17 Mr McFadden: Do they want them or is this driven by regulator's demands?

Dr Long: Risk has always been talked about by boards of directors; it was just where it was talked about. There are still various places where risk is talked about. The audit risks are talked about in the audit committee. The risk committee now deals with a whole other section of risk. Some risks are brought to the board, while others are escalated to the board from the committee structure. What worries me about having lots of committees and a huge delegation of work with a number of people serving in a different places is what I mentioned earlier, which is that not enough pairs of eyes and ears are hearing the same thing. One of the things that I look at quite carefully now, much more carefully than I used to many years ago, is cross-committee membership. It is very important that enough people are serving on both audit and remuneration, or remuneration and risk—things that have a connection with each other. Often, when I look at the cross-committee membership, I see that perhaps only one or two people are hearing those, and one of those is the chairman of one of the committees and therefore is not really listening, but chairing the meeting. This is something that we can improve on. It comes back to the much larger point about board composition, which is incredibly complex and which cannot and should not be templated. It would be a mistake to say, "Here is what all of these people should look like and this is where they should all come from."

Mr McFadden: I am coming to that.

Dr Long: Okay. Well, I will leave it there and come back to it.

Q18 Mr McFadden: My next question will be about who these people are. It is size and structure first.

Stilpon Nestor: I shall touch on three points. Like Tracy, I also am a big fan of unitary boards. To me, the most important reason for being a fan of unitary boards is the fact that the level of delegation is a choice; it is not mandated. Having said that, the other two advantages of unitary boards is that the executive, the people who actually run the businesses, are directly accountable to shareholders, which is very important. The third one is that the board, in principle, has a better view of bench strength, of managerial talent in the company. It kind of forces executives to be a team, as opposed to being a hierarchical structure under the CEO, which is the American approach to things.

Having said that, the second point I want to make is that there is less difference in practice today, at the end of the day, between two-tier boards and unitary boards. In most two-tier boards that I know of, the supervisory boards always meet with management present. More and more of the strategic issues are pushed towards the supervisory board, albeit not in the decisive fashion they could be on a unitary board. The supervisory board has more of a remit on strategy and risk appetite.

On the other hand, we have fewer and fewer executives on unitary boards, which, to me, is a troubling development. I like to see a significant executive minority on a board—as Adrian Cadbury put it 20 years ago—but it is disappearing.

Q19 Chair: Are there any particular executives who you feel absolutely should be on the board? The CFO or whoever. Who would be your most mandated?

Stilpon Nestor: The CFO is always a very, very important person to have on the board, simply because they have a better, more in-depth view of the business as a whole and can express their view on metrics. I think the main drivers of the P&L should be on the board. A bank that is fundamentally a retail bank should have somebody on the board who represents retail. I do not think that there is a recipe for who should be on the board. Very often, it has to do with the particular focus of a bank and its business positioning.

Let me tell you something else, taking a leaf out of the Spanish banks: the Spanish banks have a lot of executives on the board, compared with others—at least more than one third of the board are executives. Those executives are not necessarily people with direct managerial responsibilities. For example, Santander has the CRO on its board. That CRO is not the CRO as we know it. He is not the head of the risk management function; he is the person on the board who oversees the CRO and the risk management function. They have split it. This is, in a sense, a full-time, so-called executive member without direct managerial responsibilities. That idea might be explored further. I know that in the past at HSBC, the people on the board—the executive segment—had a particular oversight responsibility, in addition to their day-to-day managerial duties. That is an approach one could look at.

My third point is about size. Again, our research—even though it is anecdotal, so it cannot stand up to robust scrutiny—indicates that the worst performing boards are the largest boards by far. A large board cannot discuss in any depth matters as complex as risk appetite. Risk appetite should firmly belong to the board of a bank—the whole board of the bank, not the risk committee. I basically align myself with one thing that Tracy said.

Mr McFadden: Do you want to come in on size and structure or shall I go on to who these people are, Professor Franks?

Professor Franks: I would just add two small points. I think there is good empirical evidence that size matters—up to about 12 seems to be connected with good performance, and 18 or 20 to bad performance. Although we call our board a unitary board, it really is a mixed board. It is a hybrid between the German dual board supervisory executive management and the rather old-fashioned board, which just had executives. It is a mixed board. It is in the

middle. There is very little evidence that the German board structures outperform the UK. It is interesting to think about why, so in that sense I am not sure there is a lot of reason to depart and go to a dual board structure.

Q20 Mr McFadden: We talked a little about the executive members. Thinking about the non-executive members, what is required? These are very complex institutions. The criticism during the crisis was that even the chief executives, the chief risk officers and the chief financial officers were not fully aware of what was on the balance sheets, and the risks that were being run and all the rest of it. Yet, of course, there was significant criticism of people who were spending three or four days a month on those institutions.

When big systemically important financial institutions are looking for non-executive directors, what should they be looking for? Where I am leading with this is whether these jobs are really possible at all. I do not know who to start with. Perhaps you, Dr Long. You have done all these evaluations. Who are these non-executive directors?

Dr Long: They come in all shapes and sizes. Clearly, what one wants to be comfortable with, although it is difficult to quantify, is a certain amount of knowledge about the business. One needs collectively on the non-executive side of the table enough people who know enough about how the business actually works. Unless one clearly has that, one cannot challenge the executives.

Of course, it is important to remember that non-executive directors have many roles to fulfil. One of them is of course to challenge the executive judgment and, hopefully, to add to it and also be supportive. It is not just about firing questions; it is also about understanding the answers and being able, hopefully, to add to those answers. One of the things that makes some boards more effective than others is the level of mutual trust and respect between executives and non-executives. If there is not enough industry experience or business experience on the non-executive side of the team, executives do not really respect them, and if they do not really respect them, they treat them differently. Actually, it is a very important part of the whole dynamic of the boardroom to make sure that when the non-executives offer advice or challenge, the executives are really listening to them.

Q21 Mr McFadden: Are you saying that No. 1 in the criteria for banks looking for somebody would be banking expertise and knowledge, and that they have to know their way around a bank to be effective?

Dr Long: You have to have enough of that. I would hate to see a board of directors where every single person came from the banking sector. That is a very narrow perspective. I think all boards of directors need a mix of perspectives in many different ways. I would not want to see everybody coming out of the one sector but, yes, there does have to be enough knowledge in the room about what the executives are doing, which decisions they are making and whether, in their judgment, they are the right decisions.

Then one also needs very different perspectives as well. One of the most valuable perspectives that I have seen is, for example, from serving executives, and that comes with both advantages and disadvantages. The advantage of a serving executive acting as a non-executive director is that, first, the executives think this is marvellous because they think they have somebody around the table who actually understands what they are doing every day. That is a great start.

There is something in non-executive directors who have been portfolioed for a very long time. I cannot quantify it, but there is a point at which their experience starts to become a little bit less relevant because they cannot quite remember what it felt like to be that

executive. I am not going to quantify that, but there is a point at which it starts just to seep away a little bit.

To have one or two serving executives in a room is fantastic. The disadvantage of that is that they sometimes have a different level of time to give. It comes back to one of the earlier points, “Is this a unitary board?” One of the other reasons why it is not a unitary board, and I do not think that it should really be thought about exactly like that, is that I wonder whether in the future it might be more useful to have some non-executive directors who can give enormous time and expertise in certain ways, and treat others, who are bringing different perspectives—serving executives, for example—slightly differently, by not expecting so much time from them, for example, and not criticising them when they cannot give it.

Q22 Mr McFadden: I was going to go through people, time and information, but you have raised time.

Dr Long: I am sorry. It is all connected.

Q23 Mr McFadden: It’s okay. It is all connected, so I do not mind touching on it now. This model, of the non-exec who gives three days a month, on average—is that the usual ball park?

Dr Long: In my experience it is a lot more than that.

Q24 Mr McFadden: Well, we will want to hear about that. What should be the expected time? David Walker talked about this, and called for more time from non-exec directors. Presumably there is a point where if they become semi full-time, there is a danger on the other side that their ability to stand back, question and challenge could be affected, because they effectively become employees of the organisation in the same way as the directors. Tell me what you think about the time issue.

Dr Long: I have not seen that. I have seen people dedicate enormous amounts of time, way beyond the call of duty, and have never seen them cross that line in any tangible way at all. These people are hugely professional and very experienced. They absolutely understand the role of the non-executive director, more now than ever before. I have never seen that in the portfolio of businesses that I have worked with. Others may have different experiences.

Q25 Mr McFadden: On the people and time question.

Dr Hahn: On the people side I think it is mixed up. You mentioned collective responsibility for bank failures, as opposed to the governance side. Having worked in a large bank, I can tell you that the goal of management in a large bank, going back 20 years, was to get reduced regulation and less serious regulation, and to get Government to think that we could manage it ourselves. The concept of a collective failure was highly driven by the money that was in banking. The collective blame as to why banks failed is a little too easy to pass around.

When it comes to the group of executives and the directors on the board, I advised one of the banks the Government has a significant share in before it failed, and none of the executive directors on the board of that bank would ever have challenged the CEO at a board meeting—absolutely not. The concept of what that group of executives does, and what is observed by the non-executives, is quite interesting, and—

Q26 Mr McFadden: Sorry to interrupt, but Dr Long has just been telling us how dedicated and professional these people are, but you are saying that your experience at that particular bank was that they did not perform a challenge function at all, and they did not challenge the chief executive.

Dr Hahn: No. That was clearly absent. That came out very clearly in Lord McFall's hearings a few years back. It points to this non-executive group and how it fits in with that, and to the skill set. I beg to differ about the concept of having most of them being ex-bankers. I think the error in that is thinking that all those people would be former CEOs or risk people at banks. There are very sophisticated human resources people at banks. The No. 1 expense at an investment bank is not risk, it is people. The concept that we virtually never see a non-executive with human resources experience on the board of a bank is shocking. We have seen some IT failures this year. They have been minor, but potential IT failure could be catastrophic, yet I do not ever remember in my career seeing anybody with any IT experience on the board of a bank. You can find a varied group of experienced people whose skills are required on a bank board, who come from financial services. Maybe they come from different organisations, but they should learn to work together. It is an amazing collection of people.

One of the bigger challenges, which was raised just now, is the concept of the working non-executive versus the non-working executive. If I think back to my PhD research, directors, particularly non-executives have a combination of incentives: pay and reputation. I think Tracy touched on this indirectly. Many of my students are at the back. If I had been a non-executive on the board of a failed financial institution, I don't think I could keep teaching banking. Could I do that? I would be laughed out of the classroom.

You have a group of predominantly long-retired executives—we don't call them retired any more; I think that is seen as politically incorrect—who are dominating the non-executive community, and if they are on a bank that doesn't succeed, they go on. I have looked up people who are on the board of banks—whether it is Fortis, Royal Bank of Scotland or Lehman Brothers—and they continue to serve on other boards of directors. The downside is tricky and what we want is to figure out a way to get more working individuals—who have a full-time job- for non-executive directors. How we can develop that is really important.

Professor Franks: If I might add a slightly different point for this non-exec, the Monetary Policy Committee and the role of the non-exec there is very interesting. You may remember that there was at one point a rather big fight between the non-execs, I think, and the Governor, and the non-execs wanted to use outside resources to help inform them. The feeling—maybe not unreasonably—of the Governor was, “Well, we have all the resources inside the Bank. You don't need to look outside.” The non-execs won that battle and they used outside resources.

I wonder whether there is a lesson here for non-execs of banks, that they should have the resources not just to gather information from inside the bank but to gather information from outside the bank. We have talked about the time they need. I think it's not just time; they need resources. Looking at a bank, you need to look outside the bank and you need the resources to do that. I think that would also create more of a discussion—maybe more of a challenge. It is very difficult to challenge when you are relying on information fed to you just from inside the bank.

This suggestion raises difficulties, because if you have information from outside the bank and it disagrees with that inside the bank, it will create difficulties. But I think that non-execs of banks need outside sources of information, and resources to develop that.

Q27 Mr McFadden: May I ask you about examples? I agree with you, Dr Hahn, on responsibility. If someone robs my house, for me to blame the police for not being present is a

little bit odd; the person to blame for robbing my house is the person who committed the act of burglary, not the police for being absent. And we have perhaps had some of that.

However, there is this issue of information and job. It has become a commonplace to say, “They all missed the elephant in the room”, to quote Mr Nestor’s phrase; they didn’t see it coming, and so on. Lists of boards who didn’t see it coming are probably quite easy to cite. From your knowledge, what is the best example of a board who did see it coming, who changed the business model, who saw that it was all becoming too risky and took action accordingly? Did anybody get that right?

Dr Hahn: I think I can answer that in a somewhat different way. Risk management in a bank is a combination of intuitive experience, and also understanding greater technology and data availability. When we look back at the banks that had a good crisis, many of them were actually the ones that did poorly in the last crisis.

The ultimate example of that would be Barclays. You may recall that the largest rights issue before the financial crisis was Barclays; about a billion, I think, in the late ’80s—to go big into real estate, if I recall. It probably left Barclays’ management with a cultural change. That is a major part of this governance concept in a bank. I call it institutional memory; it is about where we have weaknesses and what we have learned.

One could compare. Going into the crisis, Credit Suisse did much better than UBS, but Credit Suisse had a very bad dotcom crisis—very, very bad—and they backed off. JP Morgan had a very, very bad dotcom crisis, and they came out looking well. The examples abound, but banks learn from that. I think there was an issue about HSBC and its chairman and CEO. HSBC is viewed in the marketplace as having a very strong management culture, which is probably due more to the fact that, in a sense, they missed some of the boom areas and did not change and hire in enormous amounts of external management. Many of their senior people are lifetime employees, whereas if we look at many of the other institutions that failed, we see that they were collections of people who were moving around banking circles.

Mr McFadden: Mr Nestor?

Stilpon Nestor: I am not sure I have too much to add on the last point, except that the banks that had a good crisis, from the narrow governance perspective, the only thing one can say about them is that they had more people on their boards—especially the chairman, and I have to say that they were all men—who understood the business much better from the governance perspective. Otherwise, I would say, although not as a general rule, that banks that had a simpler business model mostly seem to have done better during the crisis.

To come back to one of your earlier points, if I may—a lot of the points were covered—it is important to underline that expertise on bank boards is very important, but it is important in certain key positions. You need to have expertise on your risk committee, because this is about financial risk and banks, as was already mentioned, are very particular animals in the way they use risk to make their money, with risk being the centre of the business, not just something you mitigate. You need that expertise in the leadership of the board, but you also need people who are not in the “banking box”. Otherwise, your risk of groupthink is very high. It is precisely this type of groupthink that stood between those boards and understanding and seeing the elephant in the room. The elephant in the room is, of course, the regulatory issue that we mentioned before.

To give you an example of what is happening today, if you are looking at the risk profile of your bank from the regulatory vantage point, you are probably not charging any capital and not making many risk allowances, as such, for sovereign risk, because that is the Basel framework for risk weights. So you have a very different perspective and, except for the odd question or ad hoc remark, you do not have a systematic way of weighing some risks that

are not recognised—for political reasons, obviously—from the regulatory framework as it is. There are many things like that.

One point that was not mentioned, as regards people and the time they spend, is remuneration. I think bank boards require more time, the way they are today; there is no doubt about it. It is clear, from our research at least, that the most successful banks right now in Europe are banks where the directors have fewer commitments, so they spend more time in the bank. There is a clear relationship. The most successful banks spend more time looking at risk; that, again, comes out clearly. The most successful banks pay their non-executives much more, precisely because they require more time from them. This is something that needs to be addressed. We have a war on remuneration, and I think the non-executives are caught in the crossfire of this war because it is about executives.

Q28 Mr McFadden: The war on remuneration is mainly about executives.

Stilpon Nestor: It is, but they are caught in the crossfire.

Q29 Mr McFadden: Let me finish with this. Do you all believe these non-exec jobs are still really possible, in the normal understanding of it? Have they become less possible, in any meaningful sense, because of complexity? Let me put a provocative scenario to you. Might it be the case that, in some of these large, universal, very complex banks, the non-exec are doing their x days per month—however many that might be—they are keeping their fingers crossed, and they are going through the motions of challenging and questioning, but they are really hoping that nothing blows up on their watch and they get out after three or four years, having collected the fee and kept their reputations intact? They cannot meaningfully see the next thing that is going to blow up, because the organisations are just too complex.

Professor Franks: I think that it is no more difficult than if you were appointed a director of BP or Toyota. Your phrase “the next thing that is going to blow up” is not inappropriate to BP. That well cost BP 40 billion—I have forgotten whether it was dollars or pounds, but it is still a rather large sum. If I was a director at BP, I would be asking myself, “What’s the cement like on the next well?” Similarly, Toyota has recalled 1.2 million cars; I do not know what the cost is per car, but I guess it is an awful lot of money, and that is Toyota’s third or fourth recall. So I am not sure that I would feel more comfortable being a non-exec director elsewhere; the job is just as doable as it is at those companies.

Dr Hahn: Professor Franks has raised the point that this is a challenging job. I would put it like this: the moving parts in a bank move faster, and not only the moving parts. We had the allusion to a consumer example. We could jump to things like PPI and the new conduct aspects. The board directors are trying to manage risks, but, in a bank, do they also have to start thinking about what octane the fuel is you put in your car? “By the way, that thing on the pump that looks like it’s better for your car, when maybe it really isn’t”—does the board have to start considering that too?

Mr McFadden: I don’t know if anyone buys that fuel, but—

Dr Hahn: No, but the board has gone from looking not only at prudence but at conduct of, “Mr Thurso, are the rooms clean enough for you?” The expansion of this has really changed, and it really does beg the question you’ve asked: is the board capable? Probably, institutions, to answer your question, are going to become a lot simpler; it is on its way, and it is happening faster than most people realise. The range of activities undertaken by each bank is rapidly shrinking.

Mr McFadden: That is interesting.

Dr Hahn: The range of challenges is going to shrink to fit what the board can do.

Q30 Mr McFadden: So “too complex to run”, as distinct from “too big to fail”, is beginning to fix itself, you think?

Dr Hahn: Yes, rapidly. We start looking at this as regulation driven. In the marketplace, over 20 years ago, this was a very boring, mature industry. Through changes in technology, regulation or whatever we might blame this on—these things all happened—the industry was then perceived as a growth industry, and it was great; this was a growth industry that also generated money to pay dividends. Wasn’t that fantastic? If you teach corporate finance, this is the ultimate oxymoron, really. This defied our logic; we forgot about that. Banks grew, and, to touch on your remuneration subject, the leaders of banks were not paid on anything but revenue. If they had been paid on return on equity, it would have been better—not that that is the right thing to do—but they were paid on making their bank bigger, and that meant doing anything and selling more things. The shareholders cheered it on, bought the story, and now they don’t want to buy anything. The shareholders have looked and said, “How do you change this?” I think it has taken senior management and the boards of many banks about the last three years to come to grips with the new reality, but the shareholders are driving the show now and they say, “We want a simpler bank. We want to know what you do. We want to know that you’re in control.” That will change it more than anything, whether it is the Banking Commission, ring-fencing or anything. Shareholders have figured it out.

Chair: Lord McFall is dying to come in. Unless the other two have some particular insight, the former Chairman of the Treasury Committee will be let loose on you.

Q31 Lord McFall of Alcluth: Just to follow up Pat’s point about product recall, I asked a previous witness why we have never heard in financial services about such a thing as product recall. I looked up Wikipedia during the interval, which says: “A product recall is a request to return to the maker a batch or an entire production run of a product” and “is an effort to limit liability for corporate negligence (which can cause costly legal penalties) and to improve or avoid damage to publicity.” Professor Franks, you are stretching at the leash.

Professor Franks: I am not sure that “stretching” is quite the right word, but I understand what you mean, Lord McFall. I think it is a really great question. Why is it that certain industries have a culture and incentive structure to anticipate problems? You can see why Toyota did what it did, because some years ago it was behind the curve in its product recall, and its market share suffered dramatically. Its most recent product recall, listening to the comments, was an attempt to anticipate, to get in first, and to say to customers, “We’re looking after you before the regulators are.” That is important.

It is interesting that in the mis-selling scandal, the mis-selling was known about for some time. Different words may have been used, but it was known about. The banks did not try to control events by saying, “Yes, we have mis-sold to some people. We will develop an approach to try to locate them and compensate them.” Their view was, “No, we didn’t mis-sell, and we will go to the last fence, and go down with the ship. We are going to deny it.” I think it was Santander that decided to call it a day, and compensate. The difference in culture and the role of the boards is interesting, but I think the difference is cultural. This is not finance, regrettably, this is about a culture in an institution that perhaps relies on the regulator, and if the regulator does not force it to do something, it does not have to do it. The pharmaceutical industry is interesting in where it stands. Is it close to cars, or is it close to banks? I don’t know, but I would like to know the answer to the question.

Q32 Lord McFall of Alcluith: Good. Professor Hahn, the issue you can help us with is why have the bank used this as a cost of doing business? For example, the regulator was on to the banks as early as 2003 or 2004, and the Treasury Committee reported to the Competition Commission, but according to the regulator the banks got their lawyers on to it and pushed it back and back. They kept selling, and I know that in 2008 the executive team of one bank was asking its non-execs to endorse PPI, despite the unravelling problem and the chaos theory around that. How do we use regulation and so on to ensure that it is not a cost to business, and that the regulator looks at the P and L? If it had looked at the P and L, it would have seen a 75% or 80% profit. It could have said, “Why? Do we call this a market?”

Dr Hahn: You have touched on two big issues. One is very much a banking issue in the sense that revenues and risk in banks are usually very mis-timed. Financial institutions have a huge problem even attaching their expenses and revenues, let alone risk which can be much later in the future. PPI was a defective product from the day it started; it was never there.

Frankly, on the issue of growth, if I had gone back to Lloyds Bank 10 years ago, or not even that long ago, my guess would be that PPI might have been as much as 20% to 25% of retail profits in that bank. Imagine that the CEO—it is not even the CEO—or the head of the retail bank says, “I think we’re going to stop doing that, and I’ll explain to the shareholders; and, by the way, everybody else is doing this product and, of course, we have been doing it for a very long time.”

I think there was a certain culture in the banks of saying, “Until we’ve been told not to, we won’t do it.” When we are told not to, we can explain it to the shareholders, but it is a bit tricky to be the first to pull out. We have this combination of launching a new product and figuring out when the risks are, but, once the income stream starts growing, executives rarely decide to get out of it.

You have also tied in the concept of the industry’s lobbying ability. It is very easy to forget how much we glorified the banking sector not that long ago. I always joke with my kids that there used to be sports cards that could have been bankers cards 10 years ago. It was an awesome role to be a senior banker: you made a lot of money, it was there and we did not question it. We just did not question this behaviour well enough.

Even now, the PPI settlement is linked to having a new CEO at a bank. That is a classic corporate finance case of new management coming in and saying, “I want to get rid of all the overhang that’s above me, so clean it up, and I’ll get through with it.” The reason why it broke was that there was—I should not say a very, but what appeared to be—a united industry front until one bank broke the ranks. When that bank broke the ranks, then it was hard to defend. Ultimately, it comes back to the concept that revenues and risk have long been separated.

Q33 Lord McFall of Alcluith: I am mindful of my previous job as a head teacher in a school. If I just imposed rules on the boys and girls, they would get up to all sorts of funny things behind the playground shed. We had to ensure that there was a culture—of respect, of social responsibility, of fraternity, of community—saying, “You don’t behave in that way, because the consequences of behaving in that way mean that you are penalising your fellow pupils, and that you are bringing disrespect on your school and your family”. There was this broader appeal.

Can we in any way hope to get that in the banks, or will they not do anything until the headmaster, in the guise of the regulator, comes? You and I know that the regulator is always behind the curve.

Dr Hahn: One aspect of that part of PPI is the change in retailing. Today, when you walk into their premises, retailers feel that you are there to be sold something and that that is their opportunity. That is a major part of the environment.

On this concept of setting the rules for financial products, we have been struggling for about 20 years, at least, with a concept about whether we try to educate the average person to be able to buy any product from a bank. I cannot imagine the average teacher, plumber or whoever trying to figure out how to invest a pension fund for the next 20 or 30 years and get a decent return. These are ridiculous requests that we make of individuals. To think that individuals are financially sophisticated enough is part of the problem. Either we think we are going to educate individuals to buy these complex products, or we are going to end up regulating those complex products out of existence. That is a political choice; it is not for anyone else.

Q34 Lord McFall of Alcluith: Dr Long, you have boardroom experience. Many banks have set up board-level committees to oversee values, culture and reputational risk, and some have ethics committees. Do you see them taking these seriously? Most of the banks that come before us, when there has been a problem, say, “That was in the past. We have discarded that. We are doing things differently in the future, and in us you trust.”

Dr Long: I don’t really think that this is a committee issue, but a board issue. The best boards discuss these sorts of things at board level. They do not push it down into a committee unless there has been a particular problem that means that there needs to be deeper and longer debate about something.

One of the groups that directors, particularly non-executive directors, find hardest to be close to are customers in financial services. If you are on the board of a supermarket, you can go round a supermarket very easily and chat to people buying cabbage, to the sales girl and to the person on the till when one goes to pay, and get a feel for what the organisation is really like and what the people who work and shop there are like. It is much more difficult in a bank to do that.

Q35 Lord McFall of Alcluith: Sorry to interrupt you. I have my own bank in Dumbarton—HBOS and the Bank of Scotland. I know the staff there, and they know me very well. A number of staff were saying, “John, I have been here 20 years, and I am sick and tired. I have been asked to sell the one product a month to Mrs Quinn, who is 75 years of age, and then to James Spence, who is an apprentice at 23. It disturbs my conscience.” The individuals in the bank are fine, and they have worked for 30 or 40 years. There is something wrong with the structure; it is not the individuals. You can get access to individuals at branch level.

Dr Long: From a non-executive perspective, there are two things that one can do. First, one can spend more time out of the boardroom. Most effective board directors do that already. They are encouraged to visit branches, talk to people, and sit in a call centre and listen to how people react on the telephone. They are encouraged to do that. The less effective boards of directors are not encouraged to do that, or it just hasn’t become part of their culture. That is one of the ways in which people can get closer to it.

The other way in which non-executive directors, particularly, can start to give this message more directly is through remuneration. People talk about hard targets and soft targets in remuneration committees. “Soft targets” is probably the wrong phrase, because these are

values, ethics and the way of behaving. They should not be soft; they are actually as hard as the numbers.

If one is going to prioritise hard targets and, when it comes to the soft targets, somehow compromise on them because they are more difficult to quantify or talk about, one is giving entirely the wrong message to the senior team. The tone of any organisation is always set at the senior level.

Q36 Mr McFadden: Mr Nestor, any points to make?

Stilpon Nestor: On the culture issue, which I always find interesting, to me, culture is process over time and the way an organisation does things over a long time. Culture, unfortunately, is not something you can manage.

On your point, which is an important point about the proximity to the concerns of your clients, an interesting perspective might be the way Swedish banks do their business. Swedish banks give an unusually high authority to branch-level directors. It is a flat hierarchy. I am not saying all Swedish banks, but a couple that I know well. Some of these people have the right to buy or not to buy products that the “factories” in the banks make. They have a direct line to these factories.

In most other banks that I have come close to, the line is very long and goes all the way to the top and back, because these are very different parts. This might be way to look at this in retail businesses, such as the one you have described.

Again, to me, culture as a whole is something that we see but cannot really manage. For me, the most important part of culture when it comes to risk in a bank, for example, is to ask for every major proposal that goes to the board—or to the board of the retail bank, the corporate investment bank or any board within the bank, for that matter—to have a paragraph about what could go wrong, giving us what behavioural psychologists call a pre-mortem. What could go wrong? You always look at that when you make a decision. That, to me, is risk culture. That can generate risk culture.

Q37 Lord McFall of Alcluith: What concerns me—I address this to Professor Franks—is that we take oodles of evidence and have pious recommendations that kick the problem into the long grass. It can keep getting kicked along the road. Is there something radical that we need to do structurally to change things? For example, in your submission, you mentioned fiduciary duty and a return of assets. I was at a seminar with Professor John Kay, and I asked him about introducing fiduciary duty. He said, “Wonderful idea which will change the dynamics of banking, but you’re going to have the mother of all battles to even get that put forward.”

Professor Franks: I think, by the way, that John is right. I was at the Bank of England with a small group, and I developed this idea of changing fiduciary duty. Some very senior lawyers I know said to me, “Julian, this is awfully difficult. You’re going to broaden this duty so we’ll be responsible to everybody.” I said, “Let’s just narrow it down to depositors and the Government as taxpayers.” That is still very difficult. I think it is difficult, but I think the question of values is very important. Boards are not primarily responsible to equity holders, who contribute 5% or less of their capital; they are really responsible to all the providers of capital, including the Government as guarantors.

As for values, it is interesting. The London Business School has taken a long time and put a lot of effort into implementing a values programme within the business school. We have taken this very seriously. I just want to give you something that surprised me, a bit like your headmaster illustration. I am a teacher. A student walked into my room and said, “I have

copied someone else's work. I want you to cancel my grade." They were not found out; they just walked in. I have to confess I was a little surprised—this is not a regular occurrence, by the way. I wondered what values had forced that student to come in and say, "I submitted work that was not mine. I wish it to be cancelled."

How do you inculcate values? I do not think you should just leave it to boards; I think you have to make it clear to everybody in an organisation that particular values are important. I will give you one structural problem. My bank tries to sell me investment products. I often see them, because I like my bank manager and I feel I ought to say yes. I am also intrigued by how they try to sell to me. They always want to sell me their own products. I would like to buy an index fund. They do not sell index funds. I want to buy one because it costs 40 basis points a year to manage; they want to sell me a managed product that costs 200 basis points.

I think it is fundamentally wrong for a bank just to sell its own investment products. It is structurally wrong. I feel sorry for the people in the bank trying to sell it to me. They ought not to do that. I regard it as a structural problem, and it is wrong in terms of the values of the organisation. They cannot sell me the best product, because they cannot sell me other bank products. That is very bad. I regard that as a structural problem within the bank.

Q38 Lord McFall of Alcluith: Do any others think that fiduciary duty and responsibility to bondholders and depositors is pie in the sky?

Stilpon Nestor: I mentioned earlier that I have a slightly different version of this, which is that there is not a fiduciary duty to depositors but a duty of care and loyalty—specifically care—to the institution, because that is how the law is structured in the UK, but also in the whole of the European Union, and should include in the case of banks a duty for long-term solvency. It should focus on long-term solvency, which is not the case in most organisations, and is not part of company law.

Q39 Lord McFall of Alcluith: You think a statutory element, then?

Stilpon Nestor: I think it could be very useful to explore that, yes. I know that in the banking sector, for example, other European Union countries such as Germany have introduced it. To what degree this will bring a revolution in the culture of the banks, I am not that sure, but it is certainly one of the little cogs in the machine that it might be useful to tweak.

Dr Hahn: I disagree. I honestly think—part of where we started was the demands on directors—that we are creating almost completely opposite demands. Fundamentally, why do I buy a share or put equity into a bank? The reason I own a share in any company is that I want that company to take a certain degree of risk to pay me more. The day that I am a creditor of a bank, the last thing I want that institution to do is to take any more risk at all: I want them to make sure they can pay me back. I don't care if there is any growth for the shareholders—who cares? I think we confuse—

Q40 Lord McFall of Alcluith: But, Dr Hahn, surely you cannot argue against the duty of care to customers.

Dr Hahn: No. If I think about the duty of care to customers, it goes back to this period of rapid growth and over-expectation of bank shares, but now the banking industry has to get used to being a pretty boring, slow-growth business again. Your customers are your long-term profitability, and if you abuse your customers—I think this an issue of competition—

Q41 Lord McFall of Alcluith: I don't want to break confidences but the reason I am thinking of that is that I remember you and I having a nice meal one day and you told me about the duff products that your bank tried to sell you, and you would not go near them.

Dr Hahn: Absolutely. This is a question about competition in the banking industry, but why would people continue to do business with an institution that tries to sell them the wrong stuff?

Q42 Lord McFall of Alcluith: That has been very helpful to us. On the quality of board information, one of the features of the financial crisis with the banks that blew up was the fact that the non-executive directors did not know what was going on. I remember, John, that when we had the chief executive officer of an investment bank along to the Treasury Committee, I asked him to explain what a CDO was and he almost swallowed his teeth—they were his own, by the way, I think. He said that he was not there to illustrate that to me but, given that a CDO is 350-odd page document and with a CDO squared you end up with millions of pages, these people cannot understand it. Korn/Ferry did a survey earlier in the year that revealed that one in five non-execs felt out of depth in boardroom discussions because of the inadequate briefing materials, so is this a big area for us to look at. What suggestions do you have for us?

Dr Long: I think a lot has already changed, so board information is now much better than it used to be—it is more succinct, it is better signposted. Previously, I would always ask people, “Do you know why you have these papers?” and, often, they did not absolutely know whether it was for a decision, information or background, but now they know. Now, people are receiving a lot if not all of their information electronically, and one of the things we don't yet know—there has been no empirical evidence on this, as far as I know—is whether that makes a difference to the way they retain and respond to such information. Put that to one side, however, and information is getting better, more succinct and better signposted.

Secondly, training and development have definitely improved. There are many more training and teach-in sessions, as they call them, for non-executive directors. One of the other reasons, by the way, why time has escalated for non-executive directors is that they are not only going to internal training sessions by executives on what the company actually does but, particularly if they chair a committee, spending a lot of time in external development or training sessions by the big four and so on, which are putting on best practice seminars for them, or spending dedicated time with, for example, the company secretary or the risk officer. In my experience, non-execs take this very seriously and they do what they can to understand as much as they can.

Stilpon Nestor: I would agree with the thrust of what Tracy just said. It has become much better, but there is a lot to be done. One particular area I would want to focus on is the fact that you still often have supervisors asking the board actually to own a number of risk management tools that the board should not own, because there is no way that the board, given the profile of the boards that we have today, can ever understand them. You push them to rubber-stamp. For me, a typical example of that is the fact that, up until recently at least, the FSA wanted boards to approve ICAAP—the internal capital adequacy assessment process of a bank. That process is very complicated in most banks. I think it is not right to have the board actually owning ICAAP. Boards should own the principles behind ICAAP, but not ICAAP. There are more examples like that in the various jurisdictions that we look at within the European Union. That is one area.

Also, the supervisors very often push the board to own a number of risk limits and to own the upper layer of risk management. Again, that is something that management should be doing. The board should have a very close eye on these risks and on the risk profile of the

bank and the way that risk appetite is cascaded further down the organisation, but it should not own the risk limits. I have come across board audit committees—it was not even a risk committee—that owned 24 limits of market risk management, this was an investment bank. This is not something that the board could ever manage effectively.

Q43 Lord McFall of Alcluith: A last point on risk. I remember Professor Charles Goodhart and John Kay coming before the Treasury Committee a number of years ago, and I asked Professor Goodhart if people understood risk and he said, “No.” John Kay humorously said that he had been teaching it for the past 25 years at Oxford, but he had thrown his notes in the bin. Is the understanding of risk and risk management any better now?

Professor Franks: I am sure that it is better, but I want to pick up on something that Peter said that I think is important with respect to banks, which is that in very few industries except banking can a middle-ranking 35-year-old bet billions of pounds without the senior people. I cannot think of another industry.

Chair: It would be a matter reserved to the board in any other plc.

Professor Franks: This person only lost £1.3 billion. I use the word “only” because, when it was discovered, the amount of exposure was over £7 billion, so £1.3 billion seems quite a reasonable figure to have lost given what he could have. It is not that the risks are not understood; it is that the risks are often buried.

The second thing, in fairness, is that so many of these markets are illiquid that it is very difficult to know at a point in time what the market prices are, because there are no market prices. It is not that we do not understand risk. We have a reasonable understanding. It is that somebody who is well below the board can bet the bank. This 35-year-old bet billions. It is about solving that problem. It is not a problem of understanding risk; it is a problem of control.

Dr Hahn: I do not disagree. I brought up before the fact that the concept of governance starts at the board, but it goes down. You need to know the right questions to even ask. I am just wondering about training. Is it possible to train someone who ran a candy company or a tyre company actually to know what the controls are in the trading flow? My mind boggles to think that somebody could sit on a board and think that this is okay without that knowledge.

Q44 Chair: We are coming, you will be delighted to know, to the close of the session. There are a number of questions that flow from what you have said and, rather than rushing through eight questions in five minutes, may I trespass on your time further by writing down these questions and sending them to you? There are a number of questions that have come out of this interesting discussion.

All witnesses: Sure.

Q45 Chair: May I raise one thing with you that really goes to the heart of what you have been saying and what Dr Long has been saying? It stems from personal experience of being a senior independent on a board where there was considerable difficulty because the executive—and the company, basically—made it very difficult for the non-execs to challenge. One of the interesting things that I found was that there was great unwillingness on the part of the non-execs to challenge effectively or forcefully because they were worried about breaking the collegiality. The objective is always to arrive at the end of a board meeting with consensus and, rather like the smoke from the chimney, that is almost more important than how you get there.

The funny thing about this place is that we spend most of our time in adversarial debate where we can knock seven bells out of each other but then go for a drink together afterwards. When I eventually adopted that approach on the board, I found that it produced results.

Therefore, the question I would like you to take away and think about is this: how can we put some of that adversarial nature into a board? I wonder, in financial institutions, whether the chair of risk should be the leader of the opposition, and the risk officer for the company should report in the way that everybody suggests, but that the risk committee and risk chairman should have a separate risk officer who is simply charged with analysing what management has done, and empowering that chair to ask searching, challenging questions with a view to a real debate before any consensus is arrived at.

I am sorry to give you all of that in this way, but the fundamental principle behind this is: can any board made up of the good and the great—12 of them—ever come to anything other than a consensual view? They will have all mutually reassured themselves to tick all the boxes, unless someone in that organisation is officially charged with leading for the opposition; then, you get two sides to arrive at a much more argued point. Would you each like to address that for a short period? I will ask you also to take that away and think about it.

Dr Long: I would love to address that. First, I think that it does happen. I do not agree that boards of directors are more concerned with collegiality than challenge and then reaching consensus, because a great debate has been had—that does happen in boardrooms. People disagree with each other.

There are some fundamental elements here. One is that it is difficult to have one challenging voice in any team or group, actually. One challenging voice on his or her own generally does not have the effect that it should. In terms of board composition, for example, one of the things that good chairmen try to ensure is that there is more than one voice—there is more than one bit of grit in the oyster, if you like; you need several bits of grit to have an effect—and, in many boardrooms, the best boardrooms, there is.

Secondly, although everybody talks about how important the role of the chairman is in making an effective board—of course, theirs is an incredibly important role—the other important part of that is the CEO's view of the board. That is because if the CEO welcomes the board's contribution; respects the people there; listens; takes points away and sometimes changes his or her mind; is entirely open; brings things to the board early even before they know what the solution is—if they do all of those great things—it is a joy to work in the boardroom. If the CEO is the reverse of that—they do not respect the board, or they are very closed and will not bring things early because they feel that, for one reason or another, it is not very helpful—then working on the board is the reverse of that. It is then incredibly difficult to make one's contribution as a non-executive director, however good the chairman is.

To your point, I think that that is very important part of whether a board works or not, and whether a board can challenge. People can be as challenging as they like, but if the CEO does not listen to that, it is much more difficult.

Q46 Chair: But the point, if I could just put this to you, is that the common denominator in all the banks that failed, from a corporate governance point of view—there are lots of other factors, but our discussion today is about governance—is the over-dominance of either the CEO or the chairman. My observation from sitting on the Treasury Committee under John McFall was that all the boards basically thought they were being well led by charismatic, strong people who were doing a brilliant job. There was clearly no challenge. If you do not do something to institutionalise that in some way, we will be relying on those good chairmen and CEOs who follow all the best practice guidelines and we will have done nothing

to stop that single, dominant person coming back in once the memory of those events has slid away. My question is, can we take that risk with financial institutions? We can probably take that risk with BP, but, as a nation, can we take that risk with financial institutions? Should we not look to do something that will put structure into the debate?

Dr Long: I don't think we can take that risk with BP, by the way. If you take that risk with an oil and gas company, people die. That lesson is right across sectors; it is not just for banking. Very brave groups of people and boards of directors make the decision, while their organisation is still successful, to change their chief executive for exactly that reason. It takes a very brave group of people because shareholders will turn round and say, "Why on earth are you taking out our successful leader and replacing them with an unknown quantity?"

Q47 Chair: But we cannot count on the whole board being SAS types, can we? That is the point.

Dr Hahn: This is a quick suggestion. Regulators have to form, on behalf of society, a view of the risk of these institutions. Ultimately—whether it is once a year, every other year or however often—regulators should have a session with non-executives only. Regulators can ask them, "Are you liquid? We think you aren't. Explain why you have taken this position." If they cannot answer that, they fail and there is a repercussion.

Professor Franks: What is interesting about BP is that it had the equity base to meet the costs and the fines. The problem with the banks is that they did not have the equity base. Good boards are important, but they are not going to prevent a crisis; good regulators are important, but they are not going to prevent a crisis. What will prevent a crisis is high-equity capital requirements. Those that are too big to fail will have to bear high capital requirements. If they do not want to, they will have to split themselves up.

Stilpon Nestor: I agree with the last statement. Boards can only do so much. It reaches a point where burdening them with more structure becomes counter-productive, because it does not allow them to focus, and for people to take the initiative. Sometimes it is not SID or the chairperson, but somebody else on the board who takes the initiative and asks the stupid question. You always have to have somebody on the board to ask the stupid question. That is one issue here. The other issue is, yes, I do think that boards need to kick the tyres in a much more systematic way in banks than they do in other companies, precisely because they carry this systemic load on their backs. So they need to kick the tyres much more systematically. We need possibly to move a step further from the self-evaluation mentality, facilitated or not, that some of us practise, into a sort of third party governance assessment that the regulators can use.

Chair: Thank you all very much indeed. As I say, I have about eight questions that we never got to, so if I may I will write to you with those. It has been a most enlightening session, and will enable us to inform the main Commission. If there is anything else that you think we have not thought of, and you would like to put in evidence for the Commission to look at, we would be more than delighted to receive it. Thank you very much for having given us your time this afternoon. It is much appreciated.