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# How Can Financial Supervisors Improve the Effectiveness of Corporate Governance?

John Palmer and Chang Su Hoong

New initiatives are under way to improve governance, including guidelines from supervisory standard-setting bodies such as the Basel Committee on Banking Supervision. These initiatives should help, but more is needed to change board culture and behavior. Financial supervisors have an important stake in ensuring sound corporate governance as a strong underpinning for effective supervision. This paper suggests measures that financial supervisors can take to improve governance in regulated financial institutions.

## Foreword

Banks and financial institutions, as any type of private enterprise, are managed by human beings who are not immune from committing mistakes, but are able to learn from them. The same is true for regulators and supervisors. In the wake of the global financial crisis, the article by John Palmer and Chang Su Hoong is a timely contribution to the efforts to focus new regulation on the quality of governance.

Corporate governance is a historically grown set of lessons learned from experience. As Palmer and Chang observe, "weak and ineffective corporate governance in systemically important financial institutions was an important contributing factor" to the economic crisis that began in 2007. Yet, many banks have successfully tackled the challenge and improved their governance, mostly on their own, sometimes with guidance by their supervisors. Such efforts are welcomed as a complementary step for the needed critical—and self-critical—assessment of many banks' performance during the past years. Proper and responsible business conduct is certainly better than government intervention at the taxpayers' expense. Not the least, it conforms to the principles of economic freedom (article 27 of the Swiss Federal Constitution) and the subsidiarity of state action.

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The same is true for the economy's private associations and self-regulation: By setting standards for the industry, they can—to some extent—keep the house in order and contribute to avoiding mistakes in the future. Switzerland has had good experience with self-regulation, which the Financial Market Supervision Act of 2007 (FINMASA), in article 7, endorses and sets under control of the Financial Market Supervisory Authority (FINMA).

Regulators and supervisors are important "stakeholders" in financial markets. If they keep to their expertise (shared with the industry), carefully balance the costs against the benefits of their regulations, and follow a principles-based approach, they will be successful in their job. Palmer and Chang build on these time-tested and sound principles with a set of practical recommendations that are meant to infuse governance rules with performance-based criteria. Regulation for regulation's sake certainly would not contribute to avoiding any crisis in the future. But carefully shaped regulations that do not overrule the benefits of entrepreneurial responsibility may well prove successful.

Good regulation and supervision must be independent from the industry but share its expertise. As Palmer and Chang convincingly demonstrate, it would be impossible to supervise banks efficiently and proactively without knowing how they operate. That is of particular importance for a supervisory authority's governing and executive bodies. Their members' independence, by the way, appears to be more a question of character and personal integrity than of resumé.

A rule serves its purpose if it will either be voluntarily followed (which is the faster and more efficient way) or enforced by supervisory government action. To avoid "competition in laxity," regulators have to coordinate their work globally. Thus, for example, the Basel Committee on Banking Supervision and the Financial Stability Board, in dialogue with the concerned industry, have vigorously responded to the crisis. As Palmer and Chang demonstrate, effective supervision can be an important contribution to the refinement of risk management and risk-avoiding instruments, but in the case of risk management, a bank's or banking group's governing board has to perform responsibly.

Finally, legislative enactments should be at the very end of the gamut of government intervention, and legislation should limit itself to necessary rules that neither the industry nor its regulator can provide.

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# How Can Financial Supervisors Improve the Effectiveness of Corporate Governance?

John Palmer and Chang Su Hoong[1]

It is generally accepted that weak and ineffective corporate governance in systemically important financial institutions was an important contributing factor to the global financial crisis (GFC) that began in 2007. Some may find that assessment surprising, given the major regulatory as well as private sector initiatives to improve corporate governance in recent years, and the proliferation of governance literature. But, with the benefit of hindsight, it is easy to see why these efforts fell short of what was needed. The primary focus of the pre-GFC initiatives was on the characteristics of governance, particularly those that were observable and measurable. In practice, governance of financial institutions was not sufficient to prevent the behavioral excesses that contributed to the crisis, not because boards were poorly structured or had the wrong mandates, or because their members were unqualified, but rather because boards failed to challenge management and, instead, became cheerleaders for the new paradigm of unlimited liquidity, low interest rates, perpetual growth, and rapidly growing profits, bonuses, and stock-option benefits. Contributing factors may have included weaknesses in corporate values as well as in board cultures, and in the will and backbone of individual board members.

New initiatives are under way to improve governance, including guidelines from supervisory standard-setting bodies such as the Basel Committee on Banking Supervision. These initiatives should help, but more is needed to change board culture and behavior. Financial supervisors have an important stake in ensuring sound corporate governance as a strong underpinning for effective supervision. This paper suggests measures that financial supervisors can take to improve governance in regulated financial institutions.

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## Consequences of Ineffective Corporate Governance

Weak governance of financial institutions contributed to the crisis. According to Sir Christopher Hogg, head of the Financial Reporting Council in the United Kingdom, the GFC was the result of a "massive failure in governance at every level."[2] The Basel Committee, with more restraint, referred to "a number of corporate governance failures and lapses."[3]

Few who have studied the origins of the crisis would disagree. It is true that all who have been involved in financial systems—including politicians, central bankers, treasury officials, and financial regulators, as well as officers and directors of financial intermediaries—bear a heavy collective responsibility for the damage already caused and the consequences that we still face. It is also beyond dispute that weak and ineffective corporate governance of many financial institutions, particularly those of systemic importance, was one of the most important contributors to the grossly excessive risks taken and, consequently, the depth and severity of the crisis.

The *Review of corporate governance in UK banks and other financial industry entities*, led by Sir David Walker (the "Walker Review"), published on November 26, 2009, noted that the "principal deficiencies in BOFI [bank or other financial institution] boards related much more to patterns of behaviour than to organisation."[4] The Walker Review found that there was a lack of effective challenge of management by boards. Contributing factors included defective information flows, inadequate risk analysis or stress testing, and insufficient understanding of the impact of potential market events on business models.

The Basel Committee attributed the failures of governance to insufficient board oversight of senior management, inadequate risk management, and unduly complex or opaque organizational structures and activities.[5]

> *It is also beyond dispute that weak and ineffective corporate governance of many financial institutions, particularly those of systemic importance, was one of the most important contributors to the grossly excessive risks taken and, consequently, the depth and severity of the crisis.*

Based on our extensive experience in financial supervision and on private and public sector boards, we agree with both analyses. As a result of these weaknesses, financial institutions were allowed, even encouraged, by their boards to take excessive risks that included unprecedented levels of leverage and high-risk business strategies.

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2 Sir Christopher Hogg, Keynote Address at the inaugural ICSA Corporate Governance Conference (March 18, 2009). http://www.frc.org.uk/images/uploaded/documents/Keynote%20Address%20ICSA %20Corporate%20Governance%20Conference%20180309.pdf

3 Basel Committee on Banking Supervision, Consultative Document, *Principles for enhancing corporate governance* (March 2010).

4 Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities: Final recommendations* (November 26, 2009): 12.

5 Basel Committee Consultative Document (March 2010): 2.

## Financial Institution Board Responsibilities

Supervisors had a right to expect more of financial institution boards. In most countries, according to the Basel Committee, "the board and senior management are primarily responsible and accountable for the governance and performance of the bank"[6] and other regulated financial institutions. And, boards are legally responsible for the affairs of the financial institutions they oversee.[7] They have the authority to direct the activities of the institution, but delegate much of that authority to the chief executive officer, who is appointed by and can be removed by the board.

Except in extreme situations in which some supervisors may have the power to take control of financial institutions,[8] supervisors do not normally have the authority to manage the affairs of financial institutions. Depending on the jurisdiction, they may have power to approve the appointment of directors and certain senior officers and to remove individuals in such positions.[9] They may also have the power to direct an institution to cease risky or improper practices.[10] But such powers fall well short of the power to direct or manage; that power lies exclusively with the board.

> *As a result of these weaknesses, financial institutions were allowed, even encouraged, by their boards to take excessive risks that included unprecedented levels of leverage and high-risk business strategies.*

The responsibilities of the board of a financial institution are often more onerous than those of boards of other types of enterprises, because financial institutions are licensed by the state to take money from members of the public by accepting deposits, managing investments, or issuing insurance policies. Boards of these licensed entities have both explicit and implicit obligations to safeguard such monies and ensure that they remain available for the purpose for which they were entrusted to the financial institution. Among these obligations is the responsibility to ensure that financial firms are managed in a safe and sound manner[11] and in compliance with relevant legislation, regulations, and guidelines.

Financial supervisors have a right to expect that boards of financial institutions will carry out their responsibilities properly and effectively. In a number of countries, the expectations of supervisory authorities have been articulated in published documents and in direct discussions with boards, as recommended in guidance issued by various standard-setting

[6] Ibid., 29, par. 129.

[7] Bank Act of Canada, SC 1991, C 46, Current to May 28, 2010: sec. 157.

[8] Ibid., sec. 648.

[9] Ibid., sec. 647.1.

[10] Ibid., sec. 645.

[11] Prudential Standard APS 510, Governance, issued by the Australian Prudential Regulatory Authority (November 2009). The Objectives and Key Requirements of the Standard include ensuring: "that regulated financial institutions are managed in a sound and prudent manner by a competent Board of directors, which is capable of making reasonable and impartial business judgements in the best interests of the regulated institution and which gives due consideration to the impact of its decisions on depositors."

bodies such as the Basel Committee.[12] Frequently, such expectations include responsibility for overseeing the control systems within a financial institution, including risk management, internal audit, compliance, and the actuarial functions of insurance firms.

*Financial supervisors have a right to expect that boards of financial institutions will carry out their responsibilities properly and effectively.*

In the countries and financial sectors most affected by the crisis, boards of financial institutions cannot have been in doubt about the supervisors' general expectations, although it must be said that supervisors in a number of countries did not do enough to express concerns about risky practices to boards or senior managements of financial firms.

The silence of supervisors did not relieve boards of the responsibility to ensure that financial institutions were managed in a way that protected the interests of depositors, policyholders, investors, and other relevant stakeholders. In many instances, this responsible management did not occur and state intervention was required to protect these stakeholders and the financial systems.

## How Supervisors Evaluated Board Effectiveness Pre-GFC

Before the crisis, financial supervisors took varying degrees of interest in the governance of the financial institutions they supervised. Many supervisors provided regulatory guidelines expressing their expectations regarding corporate governance,[13] in line with international standards established by the Basel Committee[14] or the International Association of Insurance Supervisors.[15] Some of them also took steps to assess compliance with such guidelines.

However, the existing regulatory guidelines often concentrated on the characteristics of good **governance** rather than on governance **performance.** Consider the following example from a U.K. FSA (Financial Services Authority) 2006 publication.[16] Under the FSA's supervisory approach in effect at that time, governance of financial firms was to be evaluated according to the following criteria:

- Role of the board in promoting a control culture
- Board reviews of policies and procedures regarding controls
- Composition of the board and board committees, and competence of members
- Existence of audit, risk, and remuneration committees

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[12] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (September 1999); *Enhancing Corporate Governance for Banking Organisations* (February 2006); Consultative Document (March 2010).

[13] For example, U.K. Financial Services Authority, *The FSA's Risk-Based Approach: A guide for Non-Executive Directors* (November 2006).

[14] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (September 1999); *Enhancing Corporate Governance for Banking Organisations* (February 2006); Consultative Document (March 2010).

[15] Insurance Core Principles and Methodology—Core Principle 9 on Corporate Governance.

[16] U.K. Financial Services Authority, *The FSA's Risk-Based Approach: A guide for Non-Executive Directors* (November 2006): 10–12.

- Independence of the board
- Management of nonexecutive director conflicts
- Proportion of nonexecutive directors to executive directors
- Terms of reference for the board and board committees
- Frequency of board meetings
- Adequacy and timeliness of information received by the board
- Direction, understanding, monitoring, and control over business activities and related risks
- Existence of policies and procedures to ensure that critical decisions are made with appropriate approval
- Existence of processes to ensure that policy overrides are minimal and exceptions are reported to management
- Appointment process for nonexecutive directors, length of tenure, and compensation
- Consideration given by the board to the relationship with the regulator
- Existence of a strategic-planning process, including objective setting, creation of short-term business and operating plans, and monitoring of implementation
- Extent to which the strategic-planning process reflects FSA's priorities, and consideration given to risk profile, financial soundness, and capital adequacy
- Participation levels on committees
- Willingness and ability to exercise independent judgement and to challenge management

For the most part, compliance with such criteria could be assessed using a tick-box approach, checking that such criteria had been met, using regulatory returns and reports from the financial institutions. In addition to its 2006 governance criteria, the U.K. FSA document indicated that it would request board minutes, key management information, and strategy documents, and that it might interview nonexecutive directors, particularly if they chaired a key committee such as audit.

*However, the existing regulatory guidelines often concentrated on the characteristics of good **governance** rather than on governance **performance**.*

Of the FSA governance criteria listed above, only two (participation levels on committees, and willingness and ability to exercise independent judgement and to challenge management) might be described as performance-related. The others might be described as characteristics of good governance.

> *Box 1:* ***What Is Meant by Board Performance?***
>
> Simply stated, board performance means the effectiveness of the board in overseeing management and the affairs of the financial institution, and ensuring that risks accepted by the financial institution can be safely managed. As suggested in the Walker Review, boards generally met the characteristics of good governance but failed to **perform** effectively.

Indeed, few financial supervisors made serious attempts to assess board performance, other than, for example, determining that the board had put in place a regular self-assessment process. In fact, some leading financial supervisors had few interactions with boards and board committees, preferring to deal directly with management.

It seems likely that many of the financial institutions that required state support during the global financial crisis had governance structures and characteristics that would have met most of the FSA criteria listed above, with the possible exception of exercising independent judgement and challenging management. However, despite characteristics that must have received a passing grade from the supervisors, board performance was often weak and appeared to have escaped adequate supervisory scrutiny (Box 1).

## Self-Evaluation of Supervisors' Performance During the GFC

Several supervisory bodies have frankly acknowledged the failures and weaknesses of their own actions during the period leading up to the global financial crisis.[17] The work of the Financial Stability Board and standard-setting bodies to strengthen financial regulation is an implicit acknowledgement of the extent to which weak financial supervision in some developed countries contributed to the crisis.

To reduce risk taking and minimize the probability and severity of future financial crises, the FSB and standard-setting bodies are actively engaged in setting new rules, particularly in such areas as regulatory capital, liquidity, and compensation. Individual supervisors are taking additional steps within their own jurisdictions.

It is clear that a key focus of the new initiatives will be the governance of regulated financial institutions and supervisory oversight of boards and board committees. For example, in March 2010, the Basel Committee issued a Consultative Document, "Principles for Enhancing Corporate Governance," updating previous guidance issued in 1999 and 2006.[18] The Basel Committee coordinated its review with the International Association of Insurance Supervisors, which is developing a set of corporate governance principles for the insurance industry.

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[17] Ben Bernake, U.S. Federal Reserve Chairman, speech to the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition (May 7, 2009); U.K. Financial Services Authority, *The Turner Review—A regulatory response to the global banking crisis* (March 2009).

[18] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (September 1999); *Enhancing Corporate Governance for Banking Organisations* (February 2006).

## New Supervisory Approach to Governance

The Basel Committee Consultative Document differs from earlier, pre-GFC guidance in several important respects. For example, the Consultative Document raises the need for, or places greater emphasis on, the following:

- Board oversight of senior management, including setting performance standards for senior management and replacing senior management when necessary;
- Establishment of a board risk committee responsible for advising the board on the bank's overall current and future risk tolerance (or appetite) and strategy, and for overseeing senior management's implementation of that strategy;
- Responsibility of the board of a parent company for adequate corporate governance across the group, and for ensuring that there are governance policies and mechanisms appropriate to the structure, business, and risks of the group and its entities;
- An independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, and resources, and with access to the board;
- Identification and monitoring of risks, including the use of stress tests and approval processes for new products;
- The role of the board in overseeing the financial institution's compensation system, including ensuring that its design and operation are consistent with prudent risk taking, and monitoring the compensation system to ensure that it operates as intended;
- Responsibility of the board to understand the structure and the organization of the group, which may be complex and opaque, including understanding the legal and operational risks and constraints of the various types of intra-group exposures and transactions and how they affect the group's funding, capital, and risk profile under normal and adverse circumstances;
- Responsibility of the board to understand the purpose, structure, and peculiar risks of any special-purpose or related structures, or in jurisdictions that could impede transparency or fail to meet international banking standards, and to mitigate the risks identified.

*However, despite characteristics that must have received a passing grade from the supervisors, board performance was often weak and appeared to have escaped adequate supervisory scrutiny.*

### *Box 2:* ***Recommendations for Supervisors***

The March 2010 Basel Committee Consultation Document sets forth five principles to assist supervisors in assessing corporate governance, recommending that supervisors:

1. Provide guidance to banks on expectations for sound corporate governance;
2. Regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices, and evaluate the bank's implementation of the principles;
3. Supplement their regular evaluation of a bank's corporate governance policies and practices by monitoring a combination of internal reports and prudential reports;
4. Require effective and timely remedial action by a bank to address material deficiencies in its corporate governance policies and practices; and have the appropriate tools for doing so;
5. Cooperate with other relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices; tools for cooperation can include memoranda of understanding, supervisory colleges, and periodic meetings among supervisors.

The Consultation Document also contemplates a more proactive role for supervisors in ensuring that banks practice good governance (Box 2).

It is evident that the Basel Committee Consultation Document reflects and will encourage greater activity on the part of financial supervisors to assess corporate governance in financial institutions, and to take steps to ensure that boards perform more effectively. In a recent speech, a senior official of the Canadian Office of the Superintendent of Financial Institutions referred to the creation of a special supervisory unit to assess corporate governance, and mentioned similar initiatives by the U.K. FSA.[19]

## The New Approach: How Effective?

The question remains: Will the new supervisory approach to corporate governance achieve necessary improvements in the effectiveness of financial institution governance? The Basel Committee Consultation Document and other recently issued documents on corporate governance have identified many of the causes of ineffective financial institution governance in the period leading up to the crisis. The resulting guidance should encourage boards to take action to improve their own effectiveness. The heightened emphasis by financial supervisors on governance should also stimulate more robust implementation.

However, it is not clear that the new initiatives will be sufficient to ensure that financial institutions, particularly those of systemic importance, will be governed effectively enough to materially reduce the risks of future financial crises. Some of the reasons for this skepticism are beyond the scope of this paper and include the level of moral hazard that has been introduced into the global financial

[19] Ted Price, Assistant Superintendent, Supervision Sector, OSFI, "Defining the New Agenda for Governance at Financial Institutions," remarks delivered to the Riskminds USA 2010 Risk Regulation Summit, Cambridge, Mass. (May 10, 2010).

system (for example, by government guarantees of bank deposits and other liabilities). Bailouts of banks and other financial institutions, some of which were of systemic importance and some of which clearly were not, also appear to have entrenched misaligned incentives in risk taking.

Another reason has to do with the difficulty of influencing and evaluating board behavior. Certain essential qualities were missing from the governance of financial institutions. For instance, there was a failure to probe the full extent of risk taking by financial firms, and an inability or unwillingness to challenge management when indications of excessive risk taking did surface. The Walker Review provides some potentially useful suggestions for addressing these issues, such as:

- A board decision-making process that institutionalizes a "challenge" function;
- Greater time commitments by nonexecutive directors;
- Selection of a board chair with the time and expertise to provide the necessary leadership to the board;
- More extensive engagement by the board in risk oversight;
- Greater involvement by institutional investors in governance oversight.

These suggestions should help, but it still may be difficult to ensure changes in often well-entrenched board behaviors without the introduction of strong incentives to make such changes. In a perfect world, greater shareholder involvement in the governance process could improve the incentives for boards to perform effectively. The Walker Review makes several thoughtful suggestions intended to enhance the engagement of institutional shareholders. However, actually effecting such engagement is likely to be an uphill battle, given the increasing dominance of short-term investors, including hedge funds, within shareholder ranks.

*Of the FSA governance criteria listed above, only two (participation levels on committees, and willingness and ability to exercise independent judgement and to challenge management) might be described as performance-related. The others might be described as characteristics of good governance.*

Under these circumstances, knowledgeable and committed financial supervisors can play an important role in improving the governance of the firms for which they have regulatory authority. But to be effective, supervisors must move beyond "box ticking" for characteristics of good governance, and find better ways to evaluate board performance.

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The Basel Committee Consultation Document offers some useful guidance to supervisors, including a recommendation that they have "supervisory processes and tools for evaluating a bank's corporate governance policies and practices. Such evaluations may be conducted through on-site inspections and off-site monitoring and should include regular communication with a bank's senior management, board, internal control functions and external auditors."[20]

The Consultation Document also recommends that supervisors assess the effectiveness of oversight of the bank's control functions (internal audit, risk management) by the bank's board: "This could include assessing the extent to which the board interacts with and meets with the representatives of the control functions."[21]

An important aspect of the Consultation Document is the emphasis on timely and effective remedial action by supervisors when governance weaknesses are detected. In particular, the Document suggests that supervisors "set a timetable for completion…" and "have escalation procedures in place to require more stringent or accelerated remedial action in the event that a bank does not adequately address the deficiencies identified."[22]

## Five Suggestions for Supervisors

Financial supervisors should be able to enhance their impact on the governance process by adopting these Basel Committee recommendations. But we believe that more can be done to ensure the level of governance performance needed to make sure that financial institutions are safer and more prudently managed. In particular, we suggest the following:

1. **Review agendas and supporting material for meetings of the board and board committees.**

   Look for:

   - Agendas that address key risk areas and offer sufficient time for discussion, questions, and challenges, as needed;
   - Supporting material that is current and adequate to provide board or committee members with a good understanding of the issues.

   Where these conditions do not exist, it will be difficult for boards and board committees to perform effectively.

[20] Basel Committee Consultative Document (March 2010): 29.

[21] Ibid., 30.

[22] Ibid., 31.

2. **Focus on what actually takes place in meetings of the board and key board committees.**

   Supervisors have several means they can use to assess what takes place in board and board committee meetings, including the effectiveness of the board challenge function. For example, they can:

   - Review minutes of board and board committee meetings to look for: 1) wide participation by board or committee members, rather than dominance by one member; 2) evidence of challenges by board members of management, such as questions, follow-up questions, and requests for further information and subsequent updates; and 3) refusals to approve management recommendations, or granting of approvals with conditions attached;
   - Review subsequent minutes to look for indications that concerns raised or requests made at board or committee meetings were followed up;
   - Hold periodic meetings with individual board members, such as the board chair or chairs of key committees, to seek information on how the board and its committees carry out their work and exercise their challenge function;
   - Attend board or board committee meetings (see Suggestion 5, below).

3. **Initiate and maintain an active program of onsite supervision.**

   Many financial supervisors conduct most of their supervisory work offsite, reviewing regulatory returns, financial information, and other information furnished by the financial institution. In our experience, this approach is ineffective for supervising large and complex financial institutions, even if onsite work is outsourced to external auditors or other expert persons not employed by the supervisor. For governance oversight, supervision conducted largely offsite will encourage a tick-box approach, checking only for the existence of good governance characteristics.

   In the absence of onsite inspections carried out by their own teams, supervisors cannot develop sufficient knowledge of the financial institution and its business practices to be able to understand the major risks and vulnerabilities.[23] If supervisors do not have adequate understanding of the institution and its risks, they will have difficulty assessing the effectiveness of the governance process in controlling such risks. Notably, the Basel Committee's Core Principles do not require a robust program of onsite supervision, but instead portray it as an optional adjunct to offsite monitoring. [24]

[23] John Palmer, "Can we enhance financial stability on a foundation of weak supervision?" *Banco de Espana, Establidad Financiera*, no. 17 (November 2009): 47.

[24] Basel Committee on Banking Supervision, *Core Principles on Banking Supervision: Principle 21—Supervisory reporting*. "Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external expert."

4. **Develop a good understanding of the key risks and controls that supervisors would like the board to oversee.**

   Although supervisors should be able to rely on the board and board committees to provide effective oversight of the key risks of a financial firm as well as the controls over those risks, supervisors will not be able to assess the effectiveness of the board's oversight unless the supervisors, themselves, have a good understanding of those risks and controls. To acquire such an understanding requires significant supervisory effort that not only includes onsite supervision, referred to above, but also requires the involvement of technical risk specialists available to supervisors, ideally as members of their staff or, less ideally, as external consultants.

5. **Engage the board and key committees proactively and regularly.**

   Some financial supervisors meet regularly with the board, and with committees such as risk and audit, to report on supervisory findings and to seek board engagement in the responses of the financial institution to those findings. This regular interaction provides a valuable opportunity to ensure that board members understand the supervisors' main concerns, to remind board members of the supervisors' expectations of them, to evaluate the quality of the board and its committees, and to assess the extent to which they are prepared to take responsibility for the oversight of risk and risk management. Such meetings usually provide useful corroborative evidence of the quality of board performance.

## Conclusion

In the wake of the global financial crisis, many have used the phrase "never let a crisis go to waste"[25] to encourage urgent action to address the causes of the crisis and prevent or minimize the chances of a recurrence. It is clear that improving the governance of financial institutions has become a priority within the financial supervisory community, and some important initiatives are under way to achieve this goal. The initiatives have merit and are likely to produce some results.

However, we believe there is still too much emphasis on the characteristics of good governance and insufficient emphasis on performance. Although governance performance is inherently difficult to assess, supervisors who make extensive use of onsite inspections and actively engage boards and board committees will have a greater chance of improving the quality of governance performance in the financial institutions for which they are responsible. Supervisors should also bear in mind that reliance on the governance of financial firms is not a substitute for strong and effective supervision. Indeed, it is only through strong and effective supervision that supervisors will be able to determine whether the governance of financial firms can be relied upon.

*Although governance performance is inherently difficult to assess, supervisors who make extensive use of onsite inspections and actively engage boards and board committees will have a greater chance of improving the quality of governance performance in the financial institutions for which they are responsible.*

[25] Rahm Emanuel, former Chief of Staff to the President of the United States, interview with the *Wall Street Journal* (November 2008). "Never let a serious crisis to go to waste. What I mean by that is it's an opportunity to do things you couldn't do before."

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