Southeast Europe High Level Policy Meeting on Corporate Governance of Banks

Catherine Lawton
Nestor Advisors Ltd
9-10 December 2009, Belgrade
The Great Crash of 1929

"Migrant Mother" by Dorothea Lange

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Regulator’s limitations

Increases banks’ incentives to take risks

- Regulators have limited information
- Regulators understaffed
- Gaps in regulators coverage
- Lack of systemic regulation

Deficiencies in regulator oversight

Regulators seek to promote financial stability
Regulation’s unintended consequences

Increases banks’ incentives to take risks

- Banks game the system
  - Reserve requirements
  - Capital requirements

- Moral hazard
  - Deposit insurance
  - Lender of last resort

Regulators promote financial stability
The only rules that really matter are these: what a man can do and what a man can't do

Incentives

**Equity payoff schedule**
- Profit to equity holder
- Unlimited upside potential
- Sunk cost
- Price of shares purchased
- Loss
- Equity value

**Debt payoff schedule**
- Profit to bond holder
- Capped upside
- Loan principal
- Loss
- Bond value
Incentives

Equity payoff schedule
- Profit to equity holder
- Unlimited upside potential
- Equity value
- Sunk cost
- Loss
- Price of shares purchased

Payoff function of risk-taking
- Bank’s economic value
- Excessive risk-taking
- Increasing risk profile
- Unemployment
- Network effect of bank losses
- Icarus flying into the sun and the destruction of value
- Loss
Role of a bank board

Shareholders focus on growth

Bank boards should seek to achieve a balance

Regulator and depositors focus on stability

GROWTH

STABILITY

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Risk governance and risk appetite

Board of directors

Reviews, challenges and determines
Constant evaluation of appropriateness

All relevant risks
Firm leverage
Capital plan
Strategy

Risk appetite

Risk limits

Firm-wide communication and iterative feedback

Ongoing monitoring

Business lines
Regions

Aggregation

Risk exposure

All relevant risks

9

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### Banks whose chairs have financial industry experience

<table>
<thead>
<tr>
<th>Bank</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Nordea</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Banco Santander</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Intesa Sanpaolo</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>BBVA</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>NBG</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Erste Bank</td>
<td>❌</td>
<td>❌</td>
</tr>
<tr>
<td>Lloyds TSB</td>
<td>❌</td>
<td>❌</td>
</tr>
<tr>
<td>HBOS</td>
<td>❌</td>
<td>❌</td>
</tr>
<tr>
<td>RBS</td>
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<td>❌</td>
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</table>
Financial industry experience of risk committee members

* Dissolved at the end of 2008
Number of risk committee meetings in 2006 and 2007
Remuneration of risk committee members

<table>
<thead>
<tr>
<th>Bank</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Santander</td>
<td>115,500</td>
<td>147,000</td>
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<tr>
<td>BBVA</td>
<td>97,200</td>
<td>106,920</td>
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<tr>
<td>Commerzbank</td>
<td>23,000</td>
<td>37,500</td>
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<tr>
<td>Barclays</td>
<td>20,815</td>
<td>20,815</td>
</tr>
<tr>
<td>Lloyds TSB</td>
<td>20,815</td>
<td>20,815</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>5,946</td>
<td>5,946</td>
</tr>
</tbody>
</table>
Parable of the tiger

The tiger

The targets

The market

The banks

Market

Bank Z

Bank X

Bank Y

Liquidity level

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Thank you

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