



January 9, 2015

Basel Committee on Banking Supervision
Attn: Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Corporate Governance Principles for Banks, October 2014

Ladies and Gentlemen:

Better Markets¹ appreciates the opportunity to comment on the above-captioned consultative documents (the “Consultative Document”) of the Basel Committee on Banking Supervision (“BCBS”).

INTRODUCTION AND SUMMARY OF COMMENTS

The BCBS banking corporate governance principles of 2014 outlined in the Consultative Document as well as the principles the Committee outlined in 2010, 2006, 1999, and 1998 are reasonable and sound. However, the purely detailed description of the ideal picture of the banking industry set out in the 2014 Consultative document on a high level does not address the key practical question:

- Why did the approach to governance principles pursued by the BCBS over the last 14 years fail miserably at such great cost?

Without a detailed and comprehensive answer to this question, it is impossible to evaluate what approaches might or might not work in the future. Thus, while enhancing and revising the previous principles is a straightforward approach, the Committee must first analyze why the previously issued guidance and recommendations did not succeed in promoting and enforcing sound corporate governance.

Even though the BCBS expresses the view that the corporate governance of banks has improved over time, the persistent, pervasive and frequent reckless, wrongful, illegal and, at times, criminal conduct across the banking and finance industry, including the financial crash of 2008 and the many recent other scandals of LIBOR, FX benchmarks and

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.

commodity manipulation uncovered in and often ongoing well into 2011-2014, raise very serious questions about those claimed or perceived improvements.

To address the past and continued failures of banking corporate governance, notwithstanding numerous principles and recommendations previously issued by the BCBS, the Committee needs to step back and answer three fundamental questions before finalizing any new governance principles:

1. What are the ultimate objectives of corporate governance in the banking industry?
2. Why specifically was each of the corporate governance principles for banks issued in 1998, 1999, 2006 and 2010 not effective in improving corporate governance? Put another way, why did they so manifestly fail? And, very importantly, is the principle guidance approach an efficient and effective way to remedy the failures of corporate governance in banks?
3. What other tools and mechanisms are available to address the significant failures in the corporate governance of banks? Why or why not are they being incorporated into the proposed new corporate governance principles?

This comment letter provides answers to these questions and provides recommendations on practical steps that can be taken to produce observable and measurable improvements in the corporate governance for banks. Among the practical suggestions are recommendations to enhance the quality and granularity of data collected by banks that underlie bank risk management and mandatory disclosure of long-term bank performance measures.

BACKGROUND

In September 1998, the Basel Committee on Banking Supervision ("BCBS") released a report entitled, "Enhancing Bank Transparency."² The report stated that the BCBS "considers transparency to be a key element of an effectively supervised, safe and sound banking system."³ Moreover, the Committee noted that "to achieve transparency a bank, in its financial reports and other disclosures to the public, should provide timely information on key factors affecting market participants' assessment of banks."⁴ At the same time BCBS released a report entitled "Framework for Internal Control Systems in Banking Organizations."⁵ This report emphasized that "a system of effective internal control is a critical component of bank management and a foundation for the safe and sound operation of banking organizations."⁶ The Committee identified 13 Principles for the assessment of internal control systems. In particular the BCBS stated that:

² Basel Committee on Banking Supervision, *Enhancing Bank Transparency, Public disclosure and supervisory information that promotes safety and soundness in banking system* (September 1998).

³ *Id.*, page 26.

⁴ *Id.*, page 25.

⁵ Basel Committee on Banking Supervision, *Framework for Internal Control Systems in Banking Organization* (September 1998).

⁶ *Id.*, page 1.

- “The board of directors and senior management are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organization that emphasizes and demonstrates to all levels of personnel the importance of internal control.”⁷
- “An effective internal control system requires that there are reliable information systems in place that cover all significant activities of the bank.”⁸
- “The board of directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained.”⁹

On the basis of the above and other documents, the BCBS published in September 1999 the report “Enhancing Corporate Governance for Banking Organizations.”¹⁰ The document established seven sound corporate governance practices to be followed by banking organizations:

1. “Establishing strategic objectives and a set of corporate values that are communicated through the banking organization.”¹¹
2. “Setting and enforcing clear lines of responsibility and accountability through the organization.”¹²
3. “Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.”¹³
4. “Ensuring that there is appropriate oversight by senior management.”¹⁴
5. “Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide.”¹⁵
6. “Ensuring that compensation approaches are consistent with the bank’s ethical values, objectives, strategy and control environment.”¹⁶
7. “Conducting corporate governance in a transparent manner.”¹⁷

In April 2004, the Organization for Economic Co-Operation and Development (“OECD”) released “OECD Principles for Corporate Governance”¹⁸, which were supported

⁷ *Id.*, page 3.

⁸ *Id.*, page 4.

⁹ *Id.*, page 2.

¹⁰ Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organizations* (September 1999).

¹¹ *Id.*, page 5.

¹² *Id.*

¹³ *Id.*, page 6.

¹⁴ *Id.*, page 7.

¹⁵ *Id.*

¹⁶ *Id.*, page 8.

¹⁷ *Id.*

by the International Monetary Fund (IMF), World Bank (WB) and Financial Stability Board (“FSB”) as among the key principles for sound financial systems in the Compendium of Standards. The document once again outlined a number of principles for sound corporate governance including:

- “The corporate governance framework should ensure the strategic guidance of the company, effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.”¹⁹
- “The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.”²⁰

With respect to implementation of the outlined principles, the 2004 OECD report stated that “the Principles are non-binding and do not aim at detailed prescriptions for national legislation. Rather, they seek to identify objectives and suggest various means for achieving them.”²¹

In February 2006, the BCBS released another document addressing corporate governance “Enhancing corporate governance for banking organizations”.²² The Committee noted that the sound corporate governance principles could “assist banking organizations and their supervisors in the implementation and enforcement of sound corporate governance.”²³ The document effectively rephrased the seven principles of the 1998 BCBS document and introduced a new principle: “The board and senior management should understand the bank’s operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. ‘know-your-structure’).”²⁴

The BCBS principles were “neither intended to comprise a new element of, nor to add additional requirements to, the revised international framework for bank capital adequacy (Basel II).”²⁵

Following the global financial crisis, in October 2010 the BCBS reviewed and revised its corporate governance principles of 2006 and reaffirmed “their continued relevance and the critical importance of their adoption by banks and supervisors to ensure effective implementation of the principles.”²⁶ Substantively, the 2010 principles were a further restatement of the 1999 and 2006 BCBS principles together with the introduction of an

¹⁸ Organization for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (April 2004).

¹⁹ *Id.*, page 24.

²⁰ *Id.*, page 22.

²¹ *Id.*, page 13.

²² Basel Committee on Banking Supervision, *Enhancing corporate governance for banking organizations* (February 2006).

²³ *Id.*, page 1.

²⁴ *Id.*, page 17.

²⁵ *Id.*, page 2.

²⁶ Basel Committee on Banking Supervision, *Principles for enhancing corporate governance* (October 2010).

explicit reference to risk management and internal controls. The BCBS expanded the eight principles of 2006 into fourteen principles.

The revised BCBS document announced once again that it “is intended to assist banking organizations in enhancing their corporate governance frameworks and to assist supervisors in assessing the quality of those frameworks. It is not, however, intended to establish a new regulatory framework layered on top of existing national legislation, regulation or codes.”²⁷

The current 2014 guidelines outlined in the Consultative Document further re-arranges and re-formats the principles from the 1998, 1999, 2006 and 2010 documents, while introducing a new principle on the role of supervisors. The revised list of now 13 principles is:

1. The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank’s strategic objectives, governance framework and corporate culture. The board is also responsible for providing oversight of senior management.
2. Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.
3. The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.
4. Under the direction and oversight of the board, senior management should carry out and manage the bank’s activities in a manner consistent with the business strategy, risk appetite, incentives compensation and other policies approved by the board.
5. In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring that there is a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank’s operational structure and the risks that it poses.
6. Bank should have an effective independent risk management function, under the direction of a Chief Risk Officer (CRO), with sufficient stature, independence, resources and access to the board.
7. Risks should be identified, monitored and controlled on an ongoing bank-wide and individual basis. The sophistication of the bank’s risk management and internal control infrastructure should keep pace with changes to the bank’s risk profile, to the external risk landscape and in industry practice.

²⁷ *Id.*, page 4 (Emphasis added).

8. An effective risk governance framework requires robust communication within the bank about risk, both across the organization and through reporting to the board and senior management.
9. The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should approve the bank's compliance approach and policies, including the establishment of a permanent compliance function.
10. The internal audit function provides independent assurance to the board and support board and senior management in promoting an effective governance process and the long-term soundness of the bank. The internal audit function should have a clear mandate, be accountable to the board, be independent of the audited activities and have sufficient standing, skills, resources and authority within the bank.
11. The bank's compensation structure should be effectively aligned with sound risk management and should promote long term health of the organization and appropriate risk-taking behavior.
12. The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders, and market participants.
13. Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

The BCBS also noted in the corporate governance principles of 2014 that it has "witnessed banks strengthening their overall governance practices and supervisors enhancing their oversight process."²⁸ As referenced above and below, we are skeptical of that claim and, given the abysmal performance over the last two decades, any improvement – however modest -- might qualify as "strengthening," but it should not be cause for optimism without the robust analysis and actions recommended below.

COMMENTS

1. What are the ultimate objectives of corporate governance for banks?

The IMF/World Bank/FSB endorsed OECD Principles of Corporate Governance define the concept of corporate governance and its objectives in the following manner:

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper

²⁸ Consultative Document, page 3.

incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.²⁹

What is the objective of a corporation?

The first fundamental of implementing good bank governance is in identifying what is the primary objective and focus of a banking corporation. The general assumption is that the objective of a corporation is to maximize shareholder value and, as a result, that management's primary focus should be on increasing shareholder value according to some metric such as earnings per share or return on equity.

Analysis summarized in the Washington Post casts some doubts on this assumption of the objective of a corporation. The newspaper traces the origin of the shareholder value maximization principle to 1970, when "Nobel Prize-winning economist Milton Friedman wrote an article in the New York Times Magazine in which he famously argued that the only "social responsibility of business is to increase its profits." Then in 1976, economists Michael Jensen and William Meckling published a paper saying that shareholders were "principals" who hired executives and board members as "agents." In other words, when you are an executive or corporate director, you work for the shareholder."³⁰ This view seems to be adopted by the BCBS when it says that "the board and senior management are primarily responsible for the governance of the bank, and shareholders and supervisors should hold them accountable for this."³¹ In the US, this notion was challenged by Professor Margaret Blair of Vanderbilt University Law School. In the testimony to the US House of Representatives, Committee on Science and Technology she stated that "there is no statutory requirement in the US that corporations must maximize profits, or that directors are responsible for maximizing share value."³² When addressing the reasons for voluntary adoption of this principle, Professor Blair explained:

[T]his pressure comes from the media, from shareholder advocates and financial institutions in whose direct interest it is for the company to get its share price to go up, and from the self-imposed pressure [original underscore] created by compensation packages that provide enormous potential rewards for directors and managers if stock prices go up. And by the way, those compensation packages also impose very little downside cost on managers and directors if stock prices decline, which means that managers also often have huge incentives to cause their companies to take very big risks in their effort to achieve higher share prices.³³

²⁹ Organization for economic co-operation and development, *OECD Principles of Corporate Governance* (April 2004), page 11.

³⁰ Washington Post, *Maximizing shareholder value: the goal that changed corporate America* (August 26, 2013)

³¹ Consultative Document, page 34.

³² Dr. Margaret Mendenhall Blair, *Testimony to Committee on Science and Technology, U.S. House of Representatives, Hearing on "American Decline or Renewal? – Globalizing Jobs and Technology* (May 22, 2008), page 3.

³³ *Id.*, page 6.

Consequently, before the global regulators define good corporate governance for banks, they first need to define clearly what is the objective of a bank and what are the risks from pursuit of this objective that require regulatory intervention. If global regulators adhere to the Milton Friedman definition, then there is a need to develop and implement a well specified regulatory framework that addresses the broad interest of other stakeholders in a well-functioning banking system through legislation and regulation, taking into account the pursuit of shareholder value maximization by shareholders and executives.

Why the corporate governance of a bank differs from other corporations?

The traditional business governance framework of the majority of banks is a corporate structure of dispersed shareholders and concentrated management with a board of directors and executives owning duty to shareholders (US legal framework) or owing duty to the company (UK legal framework) or having obligation or liability to shareholders and company (the civil law approach). The importance of corporate governance and regulation for banks differs from non-financial companies because the impact of bank failure differs. In particular, given the common reliance of banks on retaining the confidence of depositors and other funding suppliers, mismanagement in a bank may cause not only a failure of one institution but may also damage confidence in other banks, raising the risks of wider bank runs and of contagious failures within the banking sector that impact severely on the overall economy. The wide-scale negative consequences of an institution failure define the immense importance of corporate governance in banks. Because the actions of a bank, its board and executives may have a major negative spillover on the economy, bank regulators prescribe detailed regulations governing banks' objectives and decision making processes to strengthen the resilience of banks.

At least two schools of thought have emerged with respect to the optimal corporate governance framework for banks. Some suggest relying on private remedies to enforce effective corporate governance, granting boards of directors' full responsibility for the company's activities. In practice, that approach would usually require the definition of detailed governance structures and processes, including clear internal documentation on risk appetite and risk management, code of conduct, etc. The Board would then take full responsibility for oversight and enforcement of the agreed company policies. The other camp recommends a clear role for banking regulation in determining the framework of bank governance. Under this approach, regulation would provide a clear delineation of the rights and responsibilities of boards of directors and executive management and of their corresponding duties. Professor Alexander of University of Cambridge remarked that given banking regulators' attempts to align risk and reward of bank operations, the "additional regulatory responsibilities for management have led some experts to observe that banking regulation is a substitute for corporate governance."³⁴ And there is an interim solution of a hybrid approach that combines regulatory measures with private remedies in the development and enforcement of bank governance. Global regulators need to formulate which is the preferred approach in implementing the corporate governance as well as to understand what are the strengths and weaknesses of each approach.

³⁴ Kern Alexander, *Corporate governance and banking regulation* (June 2004), page 3, (Emphasis added).

2. Why were the corporate governance principles for banks issued in 1998, 1999, 2006 and 2010 not effective in improving corporate governance? And is the principle guidance approach an efficient and effective way to remedy the failures of corporate governance in banks?

The BCBS banking corporate governance principles set out in 2014 as well as the principles the Committee outlined in 2010, 2006, 1999, and 1998 are reasonable and sound, but they all failed and society has suffered – and continues to suffer -- greatly as a result. Simply providing a description of the ideal picture of the banking industry in the new principles fails to address the deficiencies of the approach to governance principles pursued by the BCBS in the past. While enhancing and revising the previous principles is a straightforward approach, the Committee first needs to analyze why the previously issued guidance and recommendations failed to promote and enforce sound corporate governance for banks. Even though the BCBS expresses the view that the corporate governance of banks has improved over time, the persistent, pervasive and frequent reckless, wrongful, illegal and, at times, criminal conduct across the banking and finance industry, including the financial crash of 2008 and the many recent other scandals of LIBOR, FX benchmarks and commodity manipulation uncovered in and often ongoing well into 2011-2014, raise very serious questions about those claimed or perceived improvements.

The primary reason why the BCBS corporate governance principles of 1998, 1999, 2006 and 2010 failed is because they are not principles that are readily actionable and measurable but rather a discussion of regulatory desires for a perfect financial world. The document provides a valuable discussion and explanation on various aspects of operational activities of the bank that regulators consider beneficial to banks. Yet, the BCBS report fails to establish the ultimate overarching objectives of banks and the banking industry as participants in the broader economy and to provide a framework that takes these objectives into account.

The lack of fundamental objectives creates a vacuum. In particular, it is not possible to set out performance measures for the fulfillment of those objectives. Nor is it possible to develop effective tools to meet those objectives. In sum, there are no actual, practical guidelines for concrete action and no metrics to measure compliance with those guidelines or their effectiveness.

In practice, there appear to be tensions and conflicts between the objectives that the Board and management are judged against and the objectives desired by regulators in a perfect world. In particular, the conflict between the proposed ideals and formally stated goals for banks is that the Board and management are typically evaluated based on the short-term earnings of the institution, rather than on promoting a particular corporate culture as set out in the corporate governance framework. Typically, the system of performance measures and rewards is focused on such things as earnings per share and return on equity. If the management of companies are rewarded for excelling on those measures, they will naturally focus their efforts on achieving those performance measures. That is the reasonable man behavior acting according to known, defined and measurable incentives which should be expected by global regulators from bank management. A fundamental change in the behavior of the system requires a fundamental change of incentives and performance measures. And that means, the global regulatory community

must clearly state what it considers to be the objectives of the banks and what are the performance measures for the banking sector that underpin the framework. To overcome this fundamental flaw of the Consultative Document, a number of concrete steps need to be undertaken in addressing the key questions of corporate governance and new principles need to be introduced.

Principle 1 of the BCBS document should address the function and objectives of banks in society and economy. The definition developed by the Federal Reserve Bank of San Francisco provides a good basis for that: “[a]s a key component of the financial system, banks allocate funds from savers to borrowers in an efficient manner. They provide specialized financial services, which reduce the cost of obtaining information about both savings and borrowing opportunities. These financial services help to make the overall economy more efficient.”³⁵

Principle 2 should outline the efficient and effective implementation of those functions and objectives. That would mean that global regulators provide answers to the following questions, among others:

- What defines an efficient allocation of funds from savers to borrowers and how it is measured?
- Which information costs are being reduced and how?
- How do financial services help to make the overall economy more efficient?
- How are the interests of owners, managers, creditors, government and society balanced?

Principle 3 should outline the process of how to measure the achievement of the objectives. This principle should outline the categories of measures that banks, Board, and management will be evaluated by regulators and society. For example:

- Performance measures for contribution to overall economy
- Performance measure for efficiency and effectiveness of provided services
- Performance measures of contributing to the stability of financial system
- Performance measures of long-term wealth creation
- Performance measures of disclosure and transparency
- Performance measures of operational management
- Performance measures of market positions

The global regulatory community must clearly identify what categories of performance measures the banking industry must calculate and disclose to owners,

³⁵ Federal Reserve Bank of San Francisco, *What is the economic function of a bank?* (July 2001).

creditors and the public. In turn, auditors should be required to validate and attest the accuracy of those measures. A gradual but structured approach to introduce maximum transparency of bank business models and performance as well as delivering comparability of bank results will facilitate understanding by stakeholders and public of the trade-offs between pure short-run shareholder value maximization goals and broader objectives that promote long-term stability and profitability of banking institutions and society.

There is a critical need to move the focus of the overall financial industry away from short-term goals to long-term performance and sustainability of operations. Mandatory disclosure of the performance metrics set out above will provide a big step forward to achieve that.

The rest of the operational recommendations proposed by the regulatory community should constitute best practices of what outcome implementation of those principles should deliver and potential methods of implementation. Most importantly, there should be a clear requirement for regulators to have formal rules and regulations that address how the high level principles of bank governance are being implemented in each jurisdiction. While the implementation techniques can differ, the outcome should be comparable.

3. What other tools and mechanism are available to address the significant shortcomings in the corporate governance of banks?

With respect to guidance or best practices for implementation, the discussions of Board structure and function, management responsibilities, risk management, audit, disclosure provided in the 2014 document are a useful start to outline the possible guidance for national regulators. However, the Consultative Document treats topics of risk management, transparency and disclosure as stand-alone topics, which is necessary but not sufficient because they are also intertwined and closely related.

Accurate and available data and risk management are inseparable concepts

The 2014 version of the BCBS corporate governance principles outlined in the Consultative Document pays a lot of attention to risk management, risk identification, monitoring, controlling and communication. These elements are clearly vital to sound operation of banks. Yet a focus on governance of the outcome of bank operations based on risk management approaches ignores the essential input that determines the soundness of those operations – delivery of accurate and complete information associated with bank operations. In the report of the Study Group on Corporate Boards “Bridging Board Gaps” Richard Daly, the CEO and Director of Broadridge Financial Solutions noted that “information is the key to success.”³⁶ He further noted, “[m]ost governance problems can be solved through a combination of transparency, alignment and technology.”³⁷

A similar notion but from the risk management angle was expressed by Stephen Engdahl of GoldenSource Corporation who said:

³⁶ Bridging Board Gaps, Report of the Study Group on Corporate Boards (2011), page 40.

³⁷ *Id.*

Risk analysis doesn't work if a core piece of information is missing... It requires information about corporate entities and their associated hierarchies and relationships, including your relationship to them... It requires information about Securities of all asset classes, and the information related to them, including terms and conditions, corporate actions, prices, classification and more. It requires your firm's transactions and positions, along with those of your customers across all of their various accounts.³⁸

If BCBS believes that rigorous risk management is the essential component of the corporate governance of banks, the focus of its principles should be on collection of complete, accurate and detailed information about bank operations that should be available to owners, creditors, regulators and the public to different degrees. Regardless of how extensive or sophisticated, risk management models based on flawed assumptions and based on inaccurate or inappropriate data do not improve risk management but rather create an illusion that risk management is effective.

This was one of the many flaws, shortcomings and oversights well demonstrated by the recent JPMorgan Chase derivatives trading debacle referred to as the "London whale." Senator Carl Levin of the US Senate Permanent Subcommittee on Investigation made this clear in his remarks on March 15, 2013 during the investigation hearing on "JPMorgan Chase Whale Trades: a case history of derivatives risk and abuse":

"The whale trades also demonstrate how easily a Wall Street bank can manipulate and avoid risk controls. The financial industry assures us that it can prudently manage high risk activities, because they are measured, monitored, and limited. But as the Subcommittee report demonstrates in details, JPMorgan executives ignored a series of alarms that went off as the bank's Chief Investment Officer breached one risk limit after another. Rather than ratchet back the risk, JPMorgan personnel challenged and re-engineered the risk controls to silence the alarm. It is difficult to imagine how the American people can trust major Wall Street banks to prudently manage derivatives risk when bank personnel can readily game or ignore the risk controls meant to prevent financial disaster and taxpayer bailouts."³⁹

To overcome the inevitable limitations and failures of internal risk management systems of the banks, Board of Directors, regulators, owners and public in different degrees should have access to the underlying data of bank operations that will allow them to question, scrutinize and test the accuracy of risk assumptions and soundness of risk models and to undertake their own assessments. To achieve that, the regulatory community must demand that banks collect accurate, granular data and information that is usable for internal and external risk modeling and risk oversight.

³⁸ Stephen Engdahl, *The 12 Days of BCBS 239 - Day 4: Completeness, Tabb Forum* (10 December 2014).

³⁹ Opening statement of Senator Carl Levin (D-Mich.) U.S. Senate Permanent Subcommittee on Investigations Hearing on JPMorgan Chase Whale Trades: A Case History of Derivatives Risk and Abuses (March 15, 2013), page 2.

Mandatory disclosure of long-term performance measures

The measures currently used purportedly to reflect shareholder value maximization will typically include quarterly return on equity or earnings per share. Such short-term metrics of bank performance are at the heart of many bank governance problems. Yet it is important to understand that the short-term focus of bank performance is promoted by metrics that create incentives for banks to maximize short term returns. Consequently, the questions that should be asked include:

- Where have those metrics come from;
- Whose interests are served by those metrics;
- What are other possible metrics;
- Do shareholders (or subsets of shareholders) impose such metrics;
- Have short-term horizons of bank performance metrics motivated the short-term focus of banks;
- Have the metrics benefited the industry, society and/or the economy?

One possible answer to a number of these questions is the proliferation of asset management companies who manage the retirement and savings of retail investors based on their own short-term returns. As asset managers' ability to attract investors depends of their ability to beat the benchmark and ranking compare to other asset managers, they also focus on achieving short-term investment results. The framework promotes short-term behavior against the ultimate collective interests of retail investors and of the broader economy. The former Chairman of FDIC Sheila Bair warned about that in 2011 in her article "Lessons of the Financial Crisis: The Dangers of Short-Termism":

Short-termism also grows out of the institutional rules that govern our behavior. When executive compensation varies according to current-year earnings or stock prices, it creates incentives to maximize short-term results even at the expense of longer-term considerations. Short-term incentives tend to feed on each other through the chain of accountability. If an investment fund earns fees based on volume, and if volume varies – as it often does – with current performance, then the path of least resistance is to compensate fund managers based on current results. But ask yourself: If this investment fund is part of your 401(k), wouldn't you prefer that your fund manager be compensated at least in part based on long-term performance?⁴⁰

Against this background, regulatory mandated disclosure of long-term performance measures might be an effective regulatory policy response to refocus retail investors from short-term performance indicators to long-term sustainable growth and performance of banks. It is unlikely that asset managers will change their investment horizon any time

⁴⁰ Sheila Bair, *Lessons of the Financial Crisis: The Dangers of Short-Termism* (4 July 2011).

soon and it is also unlikely that retail investors will stop selecting asset managers based on their return ranking. Consequently, to facilitate the change in investor perceptions of the benefits of long-term versus short-term returns, the banking regulators and asset management regulators should mandate the disclosure of a number of long-term performance ratios. While adequate public discussion and consultations need to take place to define the minimum set of long-term performance indicators that banks must report to shareholders and the public, there are a number of potential measures already suggested.

John Hagel III, John Seely Brown and Lang Davison of Harvard Business Review noted “our over-reliance on ROE is problematic on many levels. ROA may foster a better view of fundamentals of the business, including asset utilization. As economic pressures mount, executives would be well advised to ask: which assets are we uniquely capable of managing?”⁴¹ Economic value added (EVA) developed by Stern Stewart is another potential candidate for the set of long-term performance measures. “EVA is a measure of profit less the cost of all capital employed. It is the only measure that properly accounts for all the complex trade-offs, often between the income statement and balance sheet, involved in creating value.”⁴² Professor Daniela Venanzi of Roma Tre University suggests measures such as the cash flow return on investment (CFROI), the shareholder value added (SVA), the economic margin (EM) and the cash flow value added (CVA) as possible candidates for the long-term performance measurement.⁴³ Or non-financial performance measures that capture “intangible assets” as suggested by Christopher Ittner and David Larcker of University of Pennsylvania.⁴⁴

The BCBS should undertake further work and public consultation to establish a minimum required set of long-term performance measures that must be prepared and disclosed by banks to their owners, creditors, regulators and general public. Moreover, the external auditors should have the responsibility to validate the accuracy of those measures and the underlying data for those measures. This will bring the necessary disclosure and transparency to the markets and public that the Consultative Document is trying to address.

⁴¹ John Hagel III, John Seely Brown and Lang Davison, *The best way to measure company performance* (March 4, 2010).

⁴² Stern Stewart & Co. Research, *EVA & Strategy* (April 2000), page 4.

⁴³ Daniela Venanzi, *Financial performance measures and value creation: a review* (December 27, 2010).

⁴⁴ Christopher Ittner, David Larcker, *Non-financial performance measures: what works and what doesn't* (December 6, 2000).

CONCLUSION

To address the egregious, repeated and devastating failure of banking corporate governance based on numerous principles and recommendation already issued by the BCBS over the decades, the Committee needs to answer three questions:

1. What are the ultimate objectives of corporate governance in the banking industry?
2. Why specifically was each of the corporate governance principles for banks issued in 1998, 1999, 2006 and 2010 not effective in improving corporate governance? Put another way, why did they so manifestly fail? And, very importantly, is the principle guidance approach an efficient and effective way to remedy the failures of corporate governance in banks?
3. What other tools and mechanisms are available to address the significant failures in the corporate governance of banks? Why or why not are they being incorporated into the proposed new corporate governance principles?

Among the practical suggestion to improve the banking operations that would contribute to the enhancement of corporate governance of banks are:

- recommendations to enhance and the quality and granularity of data collected by banks that underlie bank risk management.
- mandatory preparation and disclosure of long-term bank performance measures.

We hope these comments are helpful.

Sincerely,



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