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Viewpoint: Anticipating the New Environment for Boards
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When a bank falters, unsparing attention now centers squarely on the board table and the directors around it. As was the case in the S&L and banking crisis almost 20 years ago, individual directors — inside and outside — are facing tough challenges from the press, shareholders, lawsuits, and now regulation. In the face of this onslaught, troubled banks are looking with longing at governance and risk management improvements they wish they had made. Bankers hoping to avoid the wringer should anticipate the new standards for their board, implementing them now to head off legal and reputational risk, not to mention some hefty personal embarrassment for key directors. Having buckled under the weight of more than a few board binders, I have seen what directors face (or duck). I also have seen the worst of the rules governing bank boards and the resulting distractions from the real contribution outside directors must make.

With the current crisis creating its own challenges, a focus on board decisions is even more vital. The following is a guide to why directors have not fulfilled their role in the past and what can be done now to ensure they do. One of the major criticisms of troubled bank boards is that too many directors are too old and/or too far removed from the hands-on financial experience that would have alerted them to changing market conditions. This is a right and reasonable criticism of several boards.

However, any effort to ensure more in-tune boards cannot produce board responsibilities for all sorts of extraneous detail. To get busy directors with current experience, board time has to be targeted to critical issues where directors' expertise makes the difference. At last count, bank directors were required by the rulebook to consider more than 200 items — often so down in the weeds that only an operational specialist could make a useful contribution. Case in point: Regulation H, which requires directors to opine on bank security. Every year boards sit through presentations from the gumshoes about how many guns everyone has and where, but few directors, if any, can say much at the close of the session other than "Thank you."

Stripped of the detail, a director's core responsibility is to ensure long-term prudential operation that gives shareholders a reasonable return on their investment. Reasonable, of course, is in the eye of the beholder, so directors also must ensure that the return is evaluated with a full, forward-looking understanding of how it is adjusted for risk and how compensation is varied on a risk-adjusted return basis. To do this, directors must take a hands-on role in risk management. This does not mean they must pull the weeds for all the models and mandates that drive corporate and business-unit risk management. The danger is that new standards will require such a detailed-driven review; if this happens, board governance will only get worse as directors get more deeply mired in undue detail. To meet their real responsibilities, directors should look at risk management in the following terms.

Independence. Is the risk management desk separate from business units, senior enough to say what it thinks, funded enough to be sure of what it says, and free to give the board clear, early warnings?

Validation. How true are the projections provided to the board over time? Do the models and stress tests work? If not, why not? If capital suddenly disappears, who blew the critical call? What is the rationale for the bank's risk absorbers (capital, reserves, contingent liquidity) and how do they compare with those at other companies? If directors do not want to become de facto risk managers — and they shouldn't — they must in fact be risk management enforcers, taking meaningful action if problems emerge to ensure a disciplined corporate culture from the top down.

Conflicts. In a complex financial institution, conflicts between business units and within compensation structures are inevitable. The board must first be sure it understands all strategic conflicts. Then it should draw a line between those that are tolerated — with accompanying controls and disclosures — and those that threaten critical client, shareholder, and regulatory interests. Those conflicts, of course, should be terminated quickly. Critical outside consultants — auditors, counsel, and compensation consultants — should have clear, unconflicted responsibility to the board and, thereby, shareholders.

Stroke-of-the-pen risk. As regulated institutions, financial services firms are uniquely affected by policy developments. The M&A field, let alone the bankruptcy courts, are littered with firms that failed to anticipate critical rule changes. It's not at all difficult to see strategic policy coming. Regulatory and legislative changes almost never come out of the blue. Boards should never, ever be told that new capital is required after a rule is changed, or that a business has to be restructured because of a new law. Instead, legal and reputational risks must be fully incorporated into forward-looking risk management, so that a bank's M&A, product, and other key plans anticipate these developments, instead of reacting to them after the competition has figured them out and the catch-up costs rise.