



BANK OF ENGLAND

Speech

Governance and the role of Boards

Speech given by

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It is a pleasure to be speaking at the Westminster Business Forum again. I am going to use my time this morning to set out some thoughts on how at the PRA we are thinking about the role of governance and Boards in the prudential supervision of deposit takers, insurers and major investment firms. We work very closely with Boards, more so than in past approaches to prudential regulation, and I find it a very important, constructive and informative engagement.

There is a lot of focus at present on the Senior Managers and Certification Regime which will be implemented by next March, and on the proposal before Parliament to change one element of the test, namely the Presumption of Responsibility. This morning I am going to focus on the substance that underpins the regime. Also, I am not for the most part going to comment on the issue of diversity in Board membership, but not because I think it is unimportant, far from it.

The best place to start is the objectives given by Parliament to the PRA, namely the safety and soundness of firms that we supervise, the protection of insurance policyholders and our secondary objective in respect of competition, best described as requiring us to act in respect of the implications for competition of our own actions and inactions but only to the extent that we are not undermining our primary objectives.

At the heart of what we do in the PRA is risk assessment. Understanding how firms take and manage risk, the controls they have and the quality of risk management, is at the heart of the job of a prudential supervisor. That's what we do every day, and the standards of this work have been raised extensively since the crisis, which was very necessary. I never tire of saying that the PRA is a judgement-based supervisor, by which I mean the application of judgement against a framework of rules and regulation. As Mark Carney said recently in the context of the European Union, from which the largest part of our framework of rules and regulations comes: - "Ensuring the Bank of England has the instruments necessary to achieve its financial stability objective will depend on the EU continuing to have regulations of the highest standards, which strike the appropriate balance between harmonisation and flexibility, and which accommodate necessary national responsibilities, including for supervision". Narrow rules-based approaches to regulation create inflexibility and can be easy to arbitrage. The sensible application of judgement involves looking at a situation from several angles, and employing forward-looking tools such as stress tests.

For us, "judgement" is most certainly not a slogan. So judgement by whom, how, and to what end are reasonable questions to ask. I am going to place most emphasis today on the "by whom" question, but use that to illustrate the others. I want to consider the role of Boards, but in the broader setting of three groups of people: Executive Senior Management of firms; Boards (with Non-Executives in the majority); and Supervisors.

It is the job of senior Executives to exercise judgement on risks and returns on a day-to-day basis. I know that you could be confused to hear me say this given some of the things that are written about financial regulation, but we want firms to earn sustained and thus sustainable returns through the exercise of good business judgement. Senior Executives exercise that judgement within frameworks set by, and overseen by, their Boards, namely the overall strategy, the risk appetite and assessment frameworks and the oversight of controls and compliance. As supervisors we apply our judgement against our framework of rules and regulations, the distinctive feature of which is that they represent public policy objectives and thus the public good, which is the overall objective of the Bank of England.

I want now to focus on the role of Boards. They must be able to set a strategy and risk appetite and oversee implementation, but they do not substitute for the role of the Executive. Likewise, supervisors challenge hard and can ask for changes, but they do not substitute for the Board or the Executive.

The recent past has not been an easy story in this area. It is very understandable that in the wake of the financial crisis, there was hard questioning of the role of Senior Executives and of Boards. Change in the approach of supervision to approving senior managers was needed. It is perhaps natural given the scale of the shock, that some change went too far or not in the best direction. I think there was a rebound in the direction of wanting all Non-Executive Board members to have technical skills of a similar sort, and thus deeper technical knowledge of the business. But that is the job of an Executive. When I came back into supervision in 2011, a senior insurer told me that in the supervisory interview process at appointment all his prospective NEDs were being tested on whether they understood the mathematical underpinnings of a “Gaussian Copula”. I could not verify this story, but it would be a mistake to stock a Board full of people chosen for their expertise in probability theory and nor would that Board be diverse.

I have to say that this is not an undisputed statement, because I told this story at a general business event and someone took me to task that every member of an insurance board should be fluent in the theory of a Copula. To be clear, we do not expect Copula fluency for all.

But the moral of the story is that there is not a strong consensus on how to set the expectations of Boards so that they can perform their role. We may at times have gone too far in the direction of individual technical knowledge, and by the way it was the Copula story and others that convinced me to stop interviewing people taking up standard NED positions.

The PRA has close contact with many Boards, so as supervisors what do we expect of Boards? Three things stand out for me:-

1. we expect Boards to exercise good judgment in overseeing the running of the firm and to do so on a forward-looking basis;

2. that judgement is improved by good constructive challenge from Non-Executives. A firm's culture should promote discussion, debate and honest challenge. The alarm bells ring for us when we are told that the CEO or other Senior Executives are very sensitive to challenge;
3. so we as supervisors depend on Non-Executives, under the leadership of the Chair, to challenge the Executive in all aspects of the firm's strategy, which includes the viability and sustainability of the business model and the establishment, maintenance and use of the risk appetite and management framework. We also of course rely on the Non-Executives to mentor and coach the Executives and balancing this with the essential ability to challenge is a vital component of an effective Board.

In the terms of the Senior Managers Regime, this frames the responsibility of Boards. But, as many Board members have said to me, if only it was that simple, but you have made it so fiendishly complicated. Well, actually we didn't make it fiendishly complicated, finance has become that way itself – we didn't invent exotic derivatives. There are those who think the answer is to make finance less complicated, but in the real world there are benefits to innovation if risk management is effective.

So, how do we square the responsibilities with the complexity? Not by drowning in complexity, or by doing a Canute and trying to tell it to go away. For Boards it means having a certain level of understanding, not at the level of the maths of a Copula. The key challenge for all of us is to be able to boil the complexity down to understand what are the key drivers – which judgements are likely to matter when bad things happen in the tail of the distribution of risks.

This is a description of one of the hardest things in many walks of life – how to explain complex things in simple terms. In the Bank of England, it is a challenge we face regularly in terms of explaining complex areas of public policy – it's the same issue for our judgements on monetary policy.

So, let me put forward a proposition for Boards. It is the job of the Executive to be able to explain in simple and transparent terms these complex matters to Non-Executives. In doing so, you should understand the uncertainty around judgements, in what circumstances they could be wrong, and how there can reasonably be different ways to measure things like liquidity. Non-Executives should not be left to find the answers for themselves, and they should not feel that they have to do so out of a lack of sufficient confidence in what they are being told. In other words, they should not be pointed towards the haystack with warm wishes for the search ahead.

Let me give an illustration of this in a highly topical area for banks and insurers, internal risk models. What does a Board need to understand? Try the following:

- key elements of model design;
- significant assumptions and expert judgements;
- key sensitivities; and
- significant limitations and uncertainty in the model.

To restate, the challenge is to reduce complexity to simplicity, so that Board members feel that they understand:

- where is the model expected to work well;
- in what circumstances is it likely to break down;
- is the overall model output credible;
- what “moves the dial” in terms of key assumptions or judgements; and
- are those assumptions and judgements reasonable?

Non-Executives should be put in a position to possess a general understanding of the model and meet these expectations without detailed technical knowledge. That’s the job of the Executive, to explain complexity, provide good Management Information (to serve up the needle, to continue the saying) and enable challenge and thus accountability. If Non-Executives do not feel that they can meet these expectations, they should demand the time and support to enable them to do so, rather than head off for the haystack.

I want to conclude by putting this into a broader context of governance. I am sympathetic to the view that the demands on Non-Executives have risen to the point where it is time to stand back and take stock and find ways to improve the approach. There are three answers that I would rule out: the answer is not to go back to the good old days, because viewed with hindsight they don’t look that good; the answer is not to wish that finance should be simpler, something that is too idealistic to have relevance to today’s challenge; and the answer is not to repeal the duty of responsibility as it will apply to the Chairs of Boards and Board committees because as quite a few have said to me, “what’s all the fuss, this is just a description of what we are here to do.”

So, what might the answer be? In the work that we are doing at the PRA to overhaul our approach to supervision of governance in firms as it relates to our statutory objectives, we want to help to get this issue on the table and make real progress. My hunch, as I have explained today, is that one answer lies in the approach by which Non-Executives are informed by Executives about firms and thus for Executives to enable rigorous challenge and to be given credit for doing so even where the consequences will be sometimes uncomfortable. We will always be cautious of Executives who seem to see Non-Executives as some form of threat; the really effective Executives are those who see their Non-Executive colleagues' experience and knowledge as a means of improving the effectiveness of the Board's judgement through constructive support and challenge.

One thing is clear in our work, it is time to take stock on this issue. Thank you.