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Corporate governance challenges within the financial sector

Introduction

It is a great pleasure to be speaking at this webinar on a topic that is of particular importance for regulators, supervisors and fundamental for financial institutions.

Corporate and internal governance issues have received increased attention from various international bodies (FSB, Basel, IMF) and at EU level. Weak corporate governance, while not the direct trigger for the great financial crisis, contributed to its magnitude. Indeed, weaknesses in the governance of a number of institutions had contributed to excessive and imprudent risk-taking in the banking sector, which led to the failure of individual institutions and caused systemic issues in the EU and globally.

There was a need to correct credit institutions' weak or superficial internal governance practices identified during the financial crisis. The management body might not have always understood the complexity of the business and the risks involved, consequently failing to identify and constrain excessive risk taking in an effective manner. In some cases, the absence of effective checks and balances within credit and other financial institutions resulted in a lack of effective oversight of management decision-making, which exacerbated short-term and excessively risky management strategies.

Internal governance frameworks, including internal control and risk management mechanisms, were often not sufficiently integrated within institutions or groups. Institutions' risk appetite and strategy had not been well defined and risk methodologies lacked consistency, so that a holistic view on all risks did not exist. Internal control functions often lacked appropriate resources, status and/or expertise. The evidence shows that institutions that had already sound internal governance practices managed the financial crisis significantly better than the ones that had such weaknesses.

In recent years, sound governance arrangements have become even more important as institutions need to adapt their business model in this fast changing environment, in particular with regard to increased digitalisation, a strong competitive environment driven by FinTech and cost pressure. In addition, institutions also need to respond to new risk factors, like environmental, social and governance risks and adapt their business model to help financing the needed change of the economy. The current COVID 19 pandemic has made the importance of leadership to deal with these salient issues even more pressing.

Fundamental Elements of Governance

Trust in the reliability of the financial system is crucial if it is to contribute to the proper functioning of the economy, and good governance is a prerequisite to build trust. In this regard, the EBA has a clear mandate under the Capital Requirements Directive (Directive 2013/36/EU (CRD)) to specify, develop and harmonise credit institutions' internal governance arrangements, processes and mechanisms within the EU to ensure clear organisational structures with well-defined, transparent and consistent lines of responsibility, effective oversight by the management body, in particular in its supervisory function; to promote a sound risk culture at all levels of credit institutions and to enable competent authorities to supervise and monitor the adequacy of internal governance arrangements.[1]

To start, a strong risk culture is essential to establishing appropriate structures and avoiding misconduct and should include at least:

- **tone from the top**: the management body is responsible for setting and communicating the institution's core values and expectations. The top management should lead by example and monitor and adjust the risk culture of the credit institution as needed;

- **accountability**: relevant staff at all levels should know and understand the core values of the institution and, to the extent necessary for their role, its risk appetite and risk capacity;

- **effective communication** and challenge: a culture of open communication, democratic management styles that allow for effective challenge in which decision making processes stimulate a constructive critical attitude within the organisation;

1 The same holds true for investment firms for which we will publish early next year, in cooperation with ESMA, guidelines on internal governance for investment firms, that have been mandated under the new prudential regime for investment firms that will enter into force in June 2021, which is tailored to the size, nature and complexity of such firms.

- **incentives**: appropriate incentives, including clear performance criteria for bonuses and consequences for misconduct play a key role in aligning behaviour of staff with the institution's risk profile and its long-term interest.

The EBA supports the development of institutions' good governance, risk culture and risk management through various sets of guidelines on governance arrangements and benchmarking reports, namely on remuneration and diversity practices. The EBA Guidelines on internal governance, currently under revision to take into account the amendments introduced by CRD 5, highlight, among others, the duties and responsibilities of the management body to ensure a sustainable business model that takes into account all risks, including environmental, social and governance risks. The management body should also set out a framework for managing conflict of interest and related parties transactions are a specific source of actual or potential conflicts of interests and specific guidance have been developed for the prudent management of conflicts of interest that might be created by such transactions and to ensure that institution have appropriate decision making and oversight processes for such transactions.

The guidelines specify also the effective processes to identify, manage, monitor and report the risks the institution is, or might be, exposed to; adequate internal control mechanisms; and remuneration policies and practices that are consistent with and promote sound and effective risk management.

A prerequisite for financial institutions' sound and effective governance arrangements is that the members of the management in both their supervisory and management functions should be at all times of good repute and possess sufficient knowledge, skills and experience to perform their duties, including a sound and prudent management of the institution. The EBA, jointly with ESMA, has specified those requirements in the guidelines on the assessment of members of the management body and key function holders that are currently under revision to take into account the amendments introduced under CRD5. As part of the overall suitability assessment, individuals proposed or selected as members of the management body of an institution must have independence of mind to ensure objective and independent decision making. But not only each individual board member must be suitable, also the management body collectively must possess the adequate knowledge and skills. Our guidelines provide for further details on induction and training for board members in this regard.

To foster good decision-making, a diverse composition of the management body is desirable and, in particular, a more gender balanced board is deemed important. Indeed, diversity within the management body leads to a broader range of experience, knowledge and skills and adds different points of views to the oversight and decision making process and, thereby, enhances the functioning of the management body and addresses the phenomenon of "group think".

While the diversity of the management body is not an individual suitability criterion, diversity should be taken into account when selecting and assessing members of management bodies.

Diversity and equal access should be present also in all levels of the organisation. We will be providing new guidance on how institutions should implement gender-neutral remuneration policies. Institutions' policies must be gender neutral and measures that ensure equal opportunities for all genders should be implemented. This is not limited to the current remuneration of staff, but extends to career perspectives and the improvement of gender representation in management positions.

Equal opportunities and career planning should also contribute to a growing pool of female candidates for positions within institutions' management bodies. According to our diversity benchmarking report in 2018 only 15.13% of executive directors and 24.02% of non-executive directors in EU banks were women. We will follow up on the effectiveness of gender-neutral remuneration policies with a report within two year after the publication of the final guidelines and will continue to benchmark the composition of management bodies.

Internal governance and the regulatory agenda

It is important to recognise that a lot has been done and institutions have made progress in their governance, risk culture and risk management framework. However, room for improvement remains and the EBA is updating its guidelines in this respect in a number of areas. A changing environment and new and accelerating risks also require an adjustment in governance structures. I would like to highlight three issues: the need to link the prudential framework with the fight against financial crime, money laundering and the prevention of tax fraud; the enhancements to address IT security threats and the risks to the operational continuity of institutions in the context of an increasing concentration of outsourcing arrangements at a few large service providers; and the sustainability challenges.

In 2020, the EBA received an enhanced legal mandate to lead, coordinate and monitor the EU's efforts in fighting financial crime across the financial sector. This includes, for example, the creation of a central AML/CFT database with information from national authorities on weaknesses they identify when assessing governance arrangements of individual institutions or the fitness and propriety of members of the management body. Such information is shared with relevant authorities in this field and will also inform our work to further reduce governance weaknesses across the EU.

The AML/CFT framework should also be embedded in institutions' governance arrangements and risk management framework. The revised EBA Guidelines will clarify that managing and mitigating money laundering and financing of terrorism risk should be part of the assessments of the suitability of members of the management body and key function holders.

With regard to dividend arbitrage schemes, we are currently implementing a 10-point action plan, published earlier this year. The plan spans from providing further guidance on prudential governance and AML/CFT requirements to enhancing the supervision in relation to tax misconduct and dividend arbitrage trading schemes also known as "Cum-Ex and Cum-Cum" schemes.

Financial technologies and the importance of Environment, Social and Governance (ESG) factors will lead to further changes of institutions' governance and the EBA has received a broad set of mandates in those areas.

Institutions are adapting their business models to enhance their sustainability. Undoubtedly, this adaptation implies more digitalisation and growing importance of new financial technologies. This context raises opportunities but also risks for financial institutions. For example, financial institutions have been increasingly outsourcing part of their activities in recent years to create a more efficient business, but also to offer new services and distribution channels to clients. In this context, we see that more and more institutions use the same service providers or a limited set of service providers to gain access to new technologies like cloud outsourcing or other FinTech solutions. While those technologies can lead to a better and more efficient service for customers, such developments can also lead to new risks and. Concentrations of outsourcing to certain individual service providers may also increase the risk for the stability of the financial system within some Member States or the EU.

The recent legislative proposal by the EU COM on digital operational resilience (DORA) will strengthen the ICT third-party risk management and address concerns on rising concentration and dependencies that affect, institutions and supervisors alike. The aim is to establish an EU oversight framework for a continuous monitoring of the activities of ICT third-party service providers that are critical providers to financial institutions.

Similarly, as new financial technology applications in Artificial Intelligence (AI) become more prevalent, it is crucial to ensure that there are sound governance arrangements and appropriate consumer protection that accompany their implementation.

On the ESG front, our work is currently focused on CRDV and IFD mandates to develop a report assessing the potential inclusion of Environmental, Social and Governance risks (ESG risks) in the review and evaluation performed by competent authorities and elaborating on the arrangements, processes, mechanisms and strategies to be implemented by institutions to identify, assess and manage ESG risks. In this respect, we have just published a discussion paper for public consultation to present our understanding on the relevance of ESG risks for a sound functioning of the financial sector and, secondly, to collect comments and feedback from stakeholders with a view to further informing the EBA's report. This discussion paper includes several policy recommendations regarding the way in which institutions can embed ESG risks in their internal governance and risk management frameworks in a proportionate manner.

Conclusion

As you know, good governance is fundamental for good outcomes. Therefore, good governance should always be a priority for regulators and supervisors. Good governance has to set the culture and manner in which institutions operate. It should also be able to steer their institutions towards what they want to be a how they are planning to achieve it. The current challenges from the ongoing pandemic, the acceleration of digitalisation, the changes of business models and the emerging of new risks require a constant review and update of risk management and other governance arrangements.

The EBA has a wide range of tools to ensure a consistent, harmonised and proportionate application of governance arrangements. We will continue to monitor those practices and focus on the implementation of new legislation within our single rulebook. We will also continue to contribute to new legislative proposals with the objective of strengthening the requirements and practices in this important area that contributes to ensuring the stability of the financial market.

Thank you for your attention.