nestoradvisors CGscope

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Response to the Draft Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders

About Nestor Advisors and CGscope

Nestor Advisors is a London-based consultancy focusing exclusively on corporate governance. Most of our clients are in the financial sector but we also have significant experience in other sectors such as power, oil and gas, mining and ITC. We have worked with the boards of several UK and European banks and companies on various aspects of governance, including research and data mining. We have also helped transform the governance of several large banks and companies in the Middle East, Africa, and Latin America. Nestor Advisors regularly publishes a comparative study on the governance of the largest 25 European banks. Additionally, we are often asked to contribute to policy initiatives on governance and have advised, among others, the EU Commission, the EBRD, the IFC/World Bank, and Sir David Walker in his review of UK bank governance. Our managing director has also given evidence to the UK Parliament's Committee on Banking Standards in the context of the preparation of the new Banking Act.

CGscope is a data analytics company, founded in 2016 by the partners of Nestor Advisors, and based in London. CGscope researches and analyses financial institutions' governance arrangements in order to provide benchmarking services.

Response to the Consultation

Question 2: Are the subject matter, scope and definitions sufficiently clear?

Art. 88.2(b) of CRD IV requires a periodical, and at least annual, assessment of the structure, size, composition and performance of the management body. Art 88.2(c) requires a periodical, and at least annual, assessment of the knowledge, skills and experience of individual members of the management body and of the management body collectively. The Draft Guidelines on Internal Governance, currently under consultation, require in their paragraph 22 a periodic internal governance review that addresses many aspects of the board's work. Paragraphs 20c and 26ii of the Draft Guidelines on the Assessment of the Suitability of the Members of the Management Body and Key Function Holders (the 'Draft Guidelines') provide for individual and collective suitability assessment as 'as part of the review of the internal governance arrangements by the management body'. Paragraphs 143-144 determine the scope of these assessments. Finally, most listed banks would need to comply with national member state codes of corporate governance, which require annual board reviews, usually on a "comply or

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Explain" basis. Given the variety of 'assessment' requirements, it would be useful for the EBA/ESMA to clarify the relationship between them in the Draft Guidelines.

Question 7: Are the guidelines within Title II regarding the notions of suitability appropriate and sufficiently clear?

Some additional clarity might be required as regards the meaning of 'independence of mind' and its consequences as per paragraphs 74 and 75. We view the concept as a character trait that should be a requirement for every member of the management body (including executives, shareholder representatives etc.). There is no reason to believe that even if a director is a former employee, a member of the shareholding family or a current/former executive, he/she should not have the candour to form, express and argue their opinions in ways that might not actually serve a specific agenda of another party. The Draft Guidelines seem to adopt the same view, but require some additional clarity. Specifically, it is not clear whether the situations listed in paragraph 77 have as their only consequence the need to recognise a conflict and take suitable mitigating actions (abstain form decision making etc.) as per paragraph 79-81, or whether they might also preclude the appointment of a member. While the former is absolutely fitting for the purpose of preserving the integrity of decision-making, the latter might actually create serious confusion if read in conjunction with the 'formal' independence requirements of paragraphs 123 and 124.

Question 10: Are the guidelines within Title V regarding the suitability policy and governance arrangements appropriate and sufficiently clear?

According to paragraph 102, 'the compliance function should analyse how the suitability policy affects the institution's compliance with legislation, regulations, internal policies and procedures, and should report all identified compliance risks and issues of non-compliance to the management body, both in its management and supervisory functions'. This assigns the review of the suitability policy's impact exclusively to the compliance function. We see no reason for such 'micromanaging'. Some institutions might prefer the Company Secretariat or legal to 'own' the impact analysis of the suitability policy and report findings to the Chairman or the nomination committee, while the execution of the compliance plan would normally be under the oversight of the audit committee. Other institutions might feel more comfortable with a review by legal or internal audit. Furthermore under paragraph 105, the Draft Guidelines envisage a scenario whereby the internal audit function would provide recommendations to the management body on the design, implementation and effectiveness of the suitability policy. There is no reason not to allow freedom of choice in this respect. Ultimately, the 'owner' of the review should be the board and it should be in its discretion to assign the review to either an external or an internal party.

As per our previous comment under paragraph 102, we believe there is no reason to require the HR function specifically to have a 'focused' role in the board nomination process. Banking

practice varies on the function that supports the nomination process and in many institutions it is the Company Secretariat that underpins the process. In our opinion, it is better to leave the choice of support to the nomination committee and the board.

According to paragraph 124a, a member of the management body in its supervisory function should not be considered independent if, "… the member is a substantial shareholder of the CRD- institution, has a material financial connection with the CRD-institution, is an officer of, or is otherwise associated with a substantial shareholder of the CRD-institution. *For this purpose shares received as part of remuneration should not be taken into account*." We believe that there is no reason to introduce the exception in the last sentence. If a person is an acting executive; this exception is irrelevant, as the executive would not be independent anyway. However, if a person is a retired executive, there is no reason to consider him independent if he has a significant stake in an institution, even if he received the shares as part of a variable compensation scheme. The case of Jimmy Cayne of Bear Stearns would be a cautionary tale in this respect.

Furthermore, we think that a clarification might be required with regards to the concept of a 'substantial shareholder'. In our view, the threshold should not be set too low. We believe that board independence would be weakened, if minority shareholders, who are not dominant in the ownership structure, were not considered to be an independent board voice.

Finally, while the 3-year limit set in paragraph 124c is well within the best practice, we believe that the board should be allowed to explain why it may consider a member independent even if the 3-year period is not yet over. This approach is the one taken by the UK Corporate Governance Code. It allows more flexibility in board composition, while making the process transparent to the supervisor and the market. A clear statement to this effect in the Draft Guidelines would operationalise the qualification of the independence requirements as 'general principles' in the beginning of paragraph 124.

Question 11: Are the guidelines within Title VI regarding the assessment of suitability by institutions appropriate and sufficiently clear?

We believe that the ex post suitability assessment by the nomination committee (or the board) of members already appointed by shareholders could potentially be problematic, especially in case of a significant change in board composition. In such a scenario, there is a possibility that newly appointed members will be called to assess their own suitability. We suggest that when it comes to reviewing the suitability of already appointed members it might be better for the Competent Authority to step in directly without requiring prior review by the board or the nomination committee. This approach is more efficient, as it saves time. Also, it might actually incentivise institutions to develop adequate processes for the ex ante assessment of suitability.

The provision of paragraph 140 does not raise any controversies in the context of two-tier boards. However, when it comes to unitary boards a 'separate (collective) assessment of the

management function of the management body' can be confusing. On one hand, the assessment of individual executive performance is certainly the best practice, and a clear process to this effect should definitely be within the supervisor's expectations. On the other hand, the 'collective assessment' of the management function in a unitary board context does not make much sense (i.e. is it about assessing 'collectively' the CEO and the CFO when they are both executive directors?); that is, unless there is an effective definition of what collective forum needs to be assessed (for example, the collective assessment of the executive committee or similar top management committee). We think that for the sake of clarity the Draft Guidelines should make a distinction between the one-tier and two-tier boards on this point.

END