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EBA Consultation on draft Guidelines for assessing the suitability of members of the management body and key function holders of a credit institution

Nestor Advisors is grateful for the opportunity to comment on the EBA Consultation Paper on draft Guidelines for assessing the suitability of members of the management body and key function holders of a credit institution on the basis of our expertise in corporate governance. We hope that our comments will assist the EBA in developing regulations.

The EBA asks two questions:

Question 1:
Which criteria could be applied by institutions and competent authorities to differentiate the assessment process and the assessment criteria regarding the nature, scale and complexity of the business of the credit institution and how should such a differentiation look like?
Question 2:
Should competent authorities be required by the Guidelines to assess the policies of institutions for assessing the suitability of key function holders aiming to ensure that institutions have appropriate policies in place ensuring that key function holders would fulfil the suitability requirements?

Assessing the suitability of members of the management body and key function holders is a central responsibility of the management body. It is a truism to say that without the proper people even the most elaborately designed organizational structure is useless. A suboptimal choice of key people represents therefore an important risk that institutions face. Because of the systemic impact of the quality of directors and key function holders, the way the organization selects and nominates them becomes over time a tangible element of its "culture". Consequently, the existence of a *policy* for their assessment constitutes best practice — as opposed to an ad hoc choice made by shareholders, the board or managers without transparency and without explicit attention to specific elements of character, competence and independence. However, the content, processes and procedures that such a policy would entail might vary significantly from one institution to another.

The above suggests that while authorities should be required by the Guidelines to assess the existence and implementation of such policies, they should do so in a way

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that allows for different approaches that might reflect an institution's ownership, traditions, strategic and risk profile or other specificities.

With regards to the first question, the most important distinction to be drawn is between large systemically important financial institutions (SIFIs) versus smaller institutions. In order to address SIFIs' organizational and business complexity, it is fair to assume that an explicit policy should be required (and therefore assessed by supervisors). While it is a good practice for smaller institutions to have distinct nomination policies for board members and key function holders, this practice should not be a regulatory requirement for a number of reasons. First, doing so would further increase already high compliance costs. The steady increase of such costs post-crisis eventually increases concentration in the market as well as the size of individual institutions; this, in turn, exacerbates "too big to fail" problems. Second, a requirement to assess nomination policies for all institutions would significantly increase supervisory costs, due to the specialized talent that such a review of effectiveness of governance mechanisms would require. Finally, smaller institutions may voluntarily choose to follow best practices in order to win customers' trust and attract investors. This would enable SIFI-required practices to become a market clearing standard, without second-guessing the capacity of the market to come up with alternative approaches that might eventually prove superior to those favored by supervisors for SIFIs.

International groups and their subsidiaries is another dimension to be taken under consideration in designing the supervisory framework and remit. If a group is a SIFI, the home supervisor's remit should include oversight of nomination policies across the group, including at subsidiary level. However if a "local" subsidiary is a domestically important financial institution, the host supervisor should also be endowed with the authority to assess the effectiveness of such policies whether they originate locally or they are part of group policies.

In sum, we believe, as per the above, that competent authorities should be required to assess the policies for assessing the suitability of directors and key function holders in the case of international or local SIFIs, and consider the existence of such policies a plus for all other regulated entities under their remit.

If such policies are in place and authorities assess them on a regular basis, there might be less need for supervisors to engage in the exercise of prequalification of these persons as described in article 11.3 of the proposed Guidelines. We believe that this exercise has significant downsides in terms of shifting the responsibility for the quality of key personnel from the board and shareholders to regulators. In the end, such an exercise might in fact undermine regulators' power to question the competence of the management body, and thus achieve the contrary result to what it sought.

Finally, supervisors may wish to minimize assessment costs by relying on external, third party expert assessments. As the Basel Committee puts it, "assistance from external facilitators in carrying out board assessments can contribute to the objectivity of the process" (Principles for enhancing corporate governance, Basel Committee on Banking Supervision, Bank for International Settlements, October 2010).

About Nestor Advisors

Nestor Advisors is a London-based research and advisory firm that focuses exclusively on board governance and organisational effectiveness. We assist boards of financial institutions and companies in Europe and emerging markets with the design, implementation and evaluation of decision-making blueprints, organisational structures, controls and incentive systems. Our clients include some of the leading financial institutions in the European Union, Asia, Africa the Middle-East and Latin America.

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