

The background of the slide features a large, faint watermark of the Rutgers University seal. The seal is circular and contains the text "RUTGERS UNIVERSITY" around the perimeter and "STATE OF NEW JERSEY" at the bottom. In the center of the seal is a sunburst design.

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Preventing the Next Banking Crisis: Rethinking Governance of “Too Big to Fail Banks” Using CA/CM

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Current Bank Governance Paradigms Not Working

- Adams (2009): *“ex post, it is easy to argue that governance problems occurred, but ex ante it is not clear that boards of financial firms were doing anything much different from boards in other firms.”*
- Erkens, Hung and Matos (2010): *“firms with more independent boards and higher institutional ownership experienced worse stock returns during the crisis period.”*
- Beltratti and Stultz (2009): *“banks with more shareholder friendly boards, which are banks that conventional wisdom would have considered to be better governed, fared worse during the crisis”,*

Even Having Independent Boards Not Sufficient

- Beltratti and Stultz (2009): *“Banks receiving bailout money had boards that were more independent and bank directors earned significantly less compensation than their counterparts in nonfinancial firms. What this suggests is that board independence may not necessarily be beneficial for banks. Independent directors may not always have the expertise necessary to oversee complex banking firms.”*
- The Economist summarizes such studies: ***“The world knows less about what makes for good corporate governance than it likes to think”.***

Directors Not Taking Ownership of Risk Management

- *“My sense is that a lot of management teams and boards gave **lip service to risk**, maybe looking at the more obvious risks.”*
- *“Just the challenge of fitting all of the **compliance** activities that boards and their committees have to execute on, while still doing these broader and **perhaps more interesting things** that boards are supposed to do—in terms of providing oversight of the business, oversight of management, particularly oversight of the CEO, as well as engaging in the strategy and the direction of the company—is difficult.”*

Suggests Need For a New Paradigm for Bank Governance

- Such findings are not necessarily indications that banks cannot benefit from better governance, but rather, that governance of banks needs to be rethought.
- If, as these studies conclude, existing governance practices are ineffective, then we see that as a reason to develop a new paradigm for bank governance.
- Technology has to play a more direct role in bringing about better risk management and control.

Two Planks of Reform: Standards + Disclosure

- Creating a more effective governance regime consists of two planks: a strengthening of the standard of behavior to be required of bank boards of directors, especially with regard to risk management, combined with a new system of disclosure that will provide external stakeholders with the assurance that those standards are being met.
- Both of these elements—higher standards accompanied by more transparency—are essential if the level of governance inside banks is to improve, because not only must boards do a better job, they must be *seen* to be doing so.

Lessons from the 2002 Sarbanes-Oxley [SOX] Act Section 404

- While corporate law gives ultimate responsibility to the board, SOX act elevates role of CEO and CFO by having them sign financial statements (Section 302), and to report on the effectiveness of internal controls over financial reporting (Section 404).
- SOX 404 widely considered a failure in terms of cost, but it profoundly improved financial controls.
- SOX wrong to focus too narrowly on controls over reporting, as opposed to demanding improvements in the entire governance processes of the firm.
- Recall that SOX 404 helped jump start CA/CM adoption and drove use of technology in auditing.

Broaden Controls to Cover Risk, Governance

- The credit crisis was not a failure of banks' financial reporting processes, but of the risks inherent in their trading and investment decisions, especially with regard to subprime mortgages and such exotic derivative instruments as CDOs.
- Clearly, having effective controls over the financial reporting process may be necessary, but it is not sufficient, to ensure that banks are well managed, or that the taxpayers are not accumulating liabilities for saving banks that are considered too big to fail.
- Need to make bank managers and directors make risk management an explicit part of governance.

Sarbanes-Oxley (SOX) Section 404

- **SEC 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.**
- (a) **RULES REQUIRED.**—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—
 - (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- (b) **INTERNAL CONTROL EVALUATION AND REPORTING.**—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Alles and Friedman (2010) Revision of Section 404 of SOX

- **SEC 404. MANAGEMENT BOARD OF DIRECTORS ASSESSMENT OF INTERNAL CONTROLS.**
- (a) **RULES REQUIRED.**—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—
 - (1) state the responsibility of **management the board of directors** for establishing and maintaining an adequate internal control structure and procedures for **financial reporting the governance of the company**; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for **financial reporting the governance of the company**.
- (b) **INTERNAL CONTROL EVALUATION AND REPORTING.**—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the **management board of directors** of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Leech and Leech (2011) Revision of Section 404 of SOX

- **SEC. 404. MANAGEMENT ASSESSMENT OF ~~INTERNAL CONTROLS~~ FINANCIAL REPORTING RISK MANAGEMENT PROCESSES.**
- (a) **RULES REQUIRED.**—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain ~~an internal control~~ risk management effectiveness report, which shall—
 - (1) state the responsibility of management for establishing and maintaining ~~an~~ adequate ~~internal control structure and procedures~~ risk management processes for financial reporting; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the ~~internal control structure and procedures~~ risk management processes of the issuer for financial reporting.
- (b) **~~INTERNAL CONTROL~~ RISK MANAGEMENT PROCESSES EVALUATION AND REPORTING.**—With respect to the internal control assessment risk management processes assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Object is to Leverage 404 to Change “Rules of the Game” of Bank Governance

- By changing Section 404 in this way either:
 1. The board of directors is restored as the supreme authority for governance within the firm and they are explicitly required to implement and manage a rigorous and systematic set of controls that ensure that governance meets a given standard. (Alles and Friedman, 2010)
 2. Managers retain responsibility, but shift emphasis from internal controls to risk management. (Leech and Leech, 2011)
- Question is whether these changes can be implemented in a cost efficient way.

CA/CM as a Facilitator of a New Paradigm for Bank Governance

- These types of proposals indicate need to shift emphasis from CA to CM: “The only difference between auditing and monitoring is who is doing it”.
- Continuous Auditing has focused mainly on auditing, both internal and external. Credit crisis indicates that this is too limited a perspective, especially in banks.
- Auditors—both external and internal—come in too late and lack authority to intervene in business processes and crack down on risky bank practices.
- By bringing senior management and directors authority is restored, but increases challenge of producing usable information in a timely manner.

Rethinking CA/CM as a Governance Rather than Auditing Tool

- How can CM be forward looking enough to serve as a risk warning/risk management tool?
- How can outside information feed into the CM system in order to properly assess emerging threats?
- How can alarm floods be managed better (i.e. automated) since they will increase as scope of the system increases?
- How can visual interfaces be developed that better alert and focus attention of non-specialists, such as directors and line managers?
- Can better analytics be developed that focus on the uniquely dynamic risks and processes of banks?

Conclusion

- As CA/CM becomes increasingly mainstream, need to find ways of pushing the frontier forward.
- Governance of too big to fail banks is one of the toughest policy challenges today.
- Technology is only a means towards an end and there is much debate as to what that end is.
- Proposals touched on here are just some examples of what is being discussed, but they indicate the critical role that technology will have to play.
- Leverages comparative advantage of technology of speed and ability to process large amounts of data to create new paradigms in both CA/CM and governance.