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The implementation of the new governance rules in the banking industry: progress and outlook

ACPR
BANQUE DE FRANCE

CONTENTS

The purpose of this publication is to review the main changes in governance that have taken place in the five years since the implementation of Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV[1]).

In light of the concrete cases faced by the French Prudential Supervision and Resolution Authority (ACPR), this review sets out best practices that supervised entities should follow in order to improve their governance arrangements.

- On the composition of supervisory bodies:
  - The selection/recruitment/appointment of board members would benefit from being given a more formal structure, as none of the institutions under review had an adequate framework in place for this.
  - Moreover, while most of the institutions under review provide training for new board members, in too many instances there are no provisions in place for training members over the course of their mandate, even though this might seem appropriate given the constant changes in the environment, and especially in regulations.
  - Efforts to improve gender balance should be continued at all the institutions under review.
  - With regard to the presence of independent members on the supervisory bodies, mutual and cooperative groups are invited to develop criteria making it possible to identify individuals that have an equivalent degree of independence to that stipulated in the joint European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) Guidelines. These groups should also ensure that the members thus identified are sufficient in number to guarantee the "sound and prudent management of the business".
- With regard to the functioning of the supervisory bodies:
  - Allow a minimum of 5 days prior to the meeting for the submission to board members of documents to be discussed in the session.
  - Enhance the minutes of supervisory body meetings so that they provide details of all exchanges that occurred during the meetings and the issues that were discussed.
  - Executive and supervisory functions should be clearly separated to ensure the sound and prudent management of the institution.
- On risk management and internal control:
  - Where not already done, institutions shall formalise their risk appetite framework and ensure it is approved by the supervisory body.
  - When approving significant decisions, such as the budget, the determination of internal capital (ICAAP) or the formalisation of the preventive recovery plan, the supervisory body shall ensure that the decisions are consistent with the risk appetite framework and, where necessary, review said framework.

1 Capital Requirements Directive.

– Institutions have a duty to improve the quality of the information submitted to the supervisory body on “qualitative” risks, such as non-compliance, legal, IT, conduct/reputation risks.

– The supervisory body shall also ensure that key function holders, such as the heads of ongoing supervision or of risk management, regularly attend board meetings discussing topics within their field.

– Finally, the ACPR stresses that, in accordance with Article L. 511-59 of the French Monetary and Financial Code, supervisory bodies are required to carry out a formal periodical assessment of their governance arrangements and ensure that corrective measures are implemented to address possible shortcomings. For institutions that have put in place an appointments committee, the latter must periodically, and at least once a year, assess the knowledge, skills and experience of members of the supervisory body, both individually and collectively, in accordance with Article L. 511-100 of the Monetary and Financial Code.

Introduction

Since 2015, the governance rules for institutions supervised by the French Prudential Supervision and Resolution Authority (ACPR) have significantly changed.

For banking institutions, the entry into force in 2015 of Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), and its transposition into national law, have laid down a precise and detailed framework for the organisation and functioning of the management bodies of credit institutions (CI), financing companies (FC) and investment firms (IF).

In parallel, European supervisory authorities have issued guidelines/texts specifying, for each sector within their field of competence, the expectations of supervisors in relation to governance.

For CI, it is also important to highlight the importance of the creation of the Single Supervisory Mechanism (SSM) in November 2014, which places significant institutions under the direct supervision of the European Central Bank (ECB), with less significant institutions remaining under the ACPR's supervision.

For significant institutions, the ECB has become the decision-making body for prudential supervision, including with regard to governance issues. It has introduced practices designed to create a consistent and harmonised approach in all countries within the SSM. It has also made this one of its priorities, as highlighted in 2015 when it conducted a review of the governance of banking groups under its supervision.

Against this backdrop, the purpose of this publication is to review the main changes that have taken place in governance since these new rules were implemented five years ago.

The findings presented here are based on the analysis of extensive documentation collected from the institutions concerned, complemented by interviews with institutions' managers and heads of control functions, as well as members of their supervisory bodies (Chairman of the Board of Directors and/or Chairman of the Risk Committee). The full methodology is set out in Appendix 1 to this publication.

This review does not constitute a comprehensive and detailed inventory of all European and national regulatory provisions relating to the governance of credit institutions, financing companies and investment firms.

The aim is rather to emphasize the most important differences from the previous provisions, and draw attention to the major efforts that have been made to comply with these new rules. The review also seeks to highlight the main lessons that can be drawn from the concrete cases faced by the ACPR, and to use these to recommend best practices for supervised entities in order to improve their governance arrangements.

Governance: main post-crisis developments

The following three points are addressed in particular detail:

- the tightening of requirements on the role and composition of the supervisory body (the Board of Directors, Supervisory Board or other body with similar functions);
- the more precise definition of executive functions;
- the strengthening of internal control and risk management functions.

1 The role and composition of the supervisory body

The entry into force of CRD IV significantly strengthened the requirements regarding the role and composition of the supervisory body (i.e. the Board of Directors, Supervisory Board or other body with similar functions), and tasked the supervisor with verifying that these rules are properly implemented.

The texts applicable to the banking sector gave the supervisory body responsibility for a number of new specific tasks, in addition to those already entrusted to it under the French Commercial Code.

Under these new rules, the supervisory body must now play a prominent role in an institution's risk control, compliance and internal audit, as well as in deciding on appointments and remuneration. The most significant entities must also put in place specialised committees that report to the supervisory body: a risk committee, remuneration committee, appointments committee, audit committee.

By way of illustration, the supervisory body now bears ultimate responsibility for guaranteeing the effectiveness of the risk management system, by setting the institution's risk appetite and general risk tolerance limits, and by approving the main risk management strategies and policies. In doing so, the supervisory body must approve the institution's written policies, its internal risk assessment report, or the application documentation for an internal model.

In order to ensure that the supervisory body can adequately fulfil its mandate, the regulations have introduced criteria regarding its composition.

Individual competence

First, the profile of each member of the supervisory body must meet certain criteria laid down by the regulation. These criteria include:

- reputation;
- competencies;
- experience;
- knowledge;
- availability;
- conflicts of interest;
- honesty, integrity and independence of mind.

Collective competence

In addition to this individual analysis, the supervisory body must also justify that it has sufficient knowledge, skills and experience on a collective level to properly fulfil its tasks. This ensures it has the perspective and impartiality necessary to monitor the institution's management and take the decisions falling within its jurisdiction.

Independence and absence of conflicts of interest

To help ensure that the interests of all internal and external stakeholders are taken into account and that independent judgement is exercised where there is a real or potential conflict of interest, the management body in its supervisory function must include independent members.

The joint European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU provide that the supervisory body must comprise a sufficient number of independent members.

In this respect, it should be emphasised that the French Prudential Supervision and Resolution Authority (ACPR) complies with the guidelines, except on two points:

- Except in the specific case of the audit committees of public entities, for which Article L. 823-19 of the Commercial Code requires, in principle, the presence of an independent administrator,[2] the ACPR considers the presence of independent members on supervisory bodies and other specialised committees to be a best practice to be encouraged but not a legal or regulatory requirement. In particular, the formal independence of members of the management body and members of the risk committee and the appointments committee does not constitute a criterion of fitness under French laws and regulations which would be enforceable in the examination of an individual application. Under French law, the ACPR cannot therefore refuse an individual application solely because the supervisory body does not have an independent member.
- In addition, compliance with the criteria contained in the ESMA and EBA Guidelines (see paragraph 91) does not cover the full notion of independence, and other measures need to be taken into account in order to determine a candidate's independence, in particular any measures developed by French institutions in accordance with existing laws and regulations and which would allow the same objective of independence to be achieved.

Effectiveness in decision-making

A final point, which is not explicitly mentioned by the regulation, is also worth mentioning: the number of members of the supervisory body. The codes governing the establishment of enterprises in France (Commercial Code, Mutuality Code, Social Security Code, Monetary and Financial Code, etc.) set a maximum number of supervisory body members for each legal form of enterprise (18 for a public limited company, for example). This upper limit is often reached by many entities. Of course, the size of the supervisory body is the result of many factors that can sometimes be contradictory: the board must have all the necessary skills, be sufficiently diverse in terms of gender, age, profile, etc., but must also not have too many members to ensure that the collegiate can express itself effectively. In this regard, it should be noted that the supervisory boards of credit institutions can have up to 34 members while for financing companies they can have up to 36 members. Indeed, this was one of the European Central Bank (ECB)'s remarks following its thematic review on the governance of credit institutions published in 2015.

Compliance with the criteria on the individual and collective suitability of the supervisory body is primarily the responsibility of the institution. It is therefore up to the institution to formalise its approach in writing and to implement it.

It is then the responsibility of the supervisor to ensure that the criteria are adequately met. For credit institutions (CI), financial companies (FC) and investment firms (IF), the ACPR's supervision goes beyond ongoing supervision as the institutions are required to submit to the APCR for ex-post confirmation all new appointments and mandate renewals for members of the supervisory body within 15 days of appointment. This ensures the ACPR has updated information on the supervisory bodies of these institutions (see Appendix 2).

These new governance requirements aim to ensure that a supervisory body can monitor decisions

2 Transposition of Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.

taken by the management body and ensure the "sound and prudent management of the business". To this end, additional rules have been implemented to ensure a clear separation between the roles of the supervisory body and of the management body, whose functions have been clearly defined.

2 A more precise definition of executive functions

CRD IV provides that banks must be effectively managed by at least two persons.

Like the Chief Executive Officer (CEO) of a public limited company who has "*… the most extensive powers to act in any circumstances on behalf of the company…*" (Article L. 225-56 of the Commercial Code), the persons who effectively manage a regulated institution must have the widest possible powers.

Most of the legal forms adopted by regulated entities provide for the appointment of at least two effective managers. For example, public limited companies with a Board of Directors may appoint Delegate CEOs alongside the CEO.

For those companies with a Supervisory Board, all members of the Management Board are effective managers. The legal texts or doctrine (see position ACPR 2014-P -07 on the appointment of effective managers as defined in Article L. 511-13 and paragraph 4 of Article L. 532-2 of the Monetary and Financial Code) recall or specify, for each of the company forms used, the functions that are to be carried out by the effective management of regulated entities.

The texts also allow for the appointment of a senior executive (usually a Deputy CEO) as an effective manager. To do so, the competent body must entrust this executive with the necessary powers: he/she must have a sufficiently broad view of the company's activities and risks and, where necessary, be able to fully replace the other effective manager.

Another key principle of the regulation relates to the separation of the chair of the management body's supervisory function from his/her function as CEO. If the body tasked with supervising the actions of those carrying out the highest executive functions is headed by one of these top executives, it is easy to see how this can create a conflict of interest, which is even more difficult to resolve given the extent of the individual's powers.

For this reason, and except in rare cases justified by the principle of proportionality (see Position 2014-P-02 concerning the separation of the functions of Chairman of the Board of Directors and CEO), the holding of more than one mandate is prohibited in the banking sector.

Banking regulations grant the supervisor the power to oppose the appointment of effective managers, or the pursuit of their mandate if it finds that they do not or no longer comply with the criteria set out in the texts, which are essentially the same as those referred to above for the directors: reputation, competence, experience, knowledge, availability, absence of conflicts of interest, honesty, integrity and independence of mind.

The expected level of these criteria, excluding reputation, is adjusted in accordance with the proportionality principle. For example, in the case of the effective managers of credit institutions, the ECB considers that the required level of experience should be ten years in a similar position. However, this does not rule out individuals with less experience, provided the supervisor has all the elements necessary to compensate for the lack of experience (see the latest version of the guide to fit and proper assessment published by the ECB in May 2018).[3]

3 Strengthened internal control and risk management functions

Based on the recognition that certain risks can only be adequately controlled through requirements regarding the intrinsic governance of an institution, the effectiveness of the system of governance became a critical issue in the post-crisis adoption of regulatory frameworks for the banking sector.

In addition to the risk steering, monitoring and management functions entrusted to the supervisory body, as highlighted above, CRD IV identifies certain critical functions relating to risk management and control that need to be carried out by key function holders subject to heightened expectations.

3 *https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf*

The EBA and ESMA Guidelines on the suitability of members of the management body and key function holders (EBA/GL/2017/12) of 26 September 2017, identify key function holders, who they define as individuals with significant influence over the management of the institution. These include heads of internal control functions and the Chief Financial Officer, where they are not members of the management body, and other key function holders identified by institutions using a risk-based approach.

In France, the Decree of 3 November 2014 on the internal control of entities in the banking, payment services and investment services sectors, notably defines four key functions: the heads of ongoing supervision, periodical control, compliance and risk management.

These key functions have a single head, who is a natural person directly answerable to the CEO, the Management Board or the operational manager of the organisation. In particular, key function holders should be able to communicate with all members of the organisation or group, access all information necessary for the performance of their tasks and have the necessary independence to produce high-quality work, free of conflicts of interest.

Independence and direct access to the supervisory body and the risk committee enable key function holders to play their full advisory and information role vis-à-vis the supervisory body, while respecting the hierarchical authority of the CEO, the Delegate CEO, the members of the Management Board or the operational manager. To this end, key function holders are positioned at a hierarchical level that enables them to perform their tasks effectively and reliably.

Under the principle of proportionality applicable to small structures, a key function holder in a small institution can also hold a mandate as effective manager.

For CI, FC and IF, the ACPR is only partially compliant with the EBA and ESMA Guidelines on the suitability of members of the management body and key function holders (EBA/GL/2017/12) of 26 September 2017. Indeed, contrary to the guidelines, the French regulatory framework does not provide for the ACPR's assessment of the suitability of key position holders at each appointment or mandate renewal. However, the ACPR does assess the suitability of heads of internal control functions in the event of a change of control, and as part of its ongoing supervision of supervised institutions. It can thus oppose the pursuit of the mandate of key function holders.

Moreover, with regard to risk management, the increasing digitalisation of financial services has been accompanied by a sharp rise in the use of outsourcing, including for essential services. Outsourcing is even in some cases an intrinsic element of the business model of institutions, due to its many potential benefits: cost reduction, flexibility, access to or use of new technologies (fintechs).

However, too much reliance on outsourcing exposes institutions to additional risks in the event that the service provider encounters difficulties.

In the banking industry, the use of outsourcing has recently become more tightly regulated in Europe, notably through the publication of recommendations on outsourcing to cloud service providers (EBA/REC/2017/03) and the updating of outsourcing guidelines (EBA/GL/2019/02).

These guidelines aim to identify "critical or important functions" that require increased vigilance on the part of supervised institutions and supervisors. Supervised institutions must conduct a risk assessment prior to the conclusion of an outsourcing agreement and then monitor the contract ex-post, taking particular account of the critical or important nature of the outsourced function.

These guidelines confirm that the use of outsourcing, even where substantial, must not lead to the creation of "empty shells": the management body must remain responsible for meeting regulatory requirements, which include ensuring it has the ability to monitor the outsourcing of critical or important functions. The institution must therefore maintain the necessary internal resources to meet these requirements.

The outsourcing of critical or important functions should also be thoroughly monitored by the supervisor. To this end, the ACPR may request that institutions provide it with a full list of all outsourced functions, and all plans for outsourcing critical or important functions must be submitted to it annually in the institutions' internal control reports.

Finally, the Decree of 3 November 2014 on the internal control of entities in the banking, payment services and investment services sectors subject to supervision by the ACPR, requires such entities to outsource all tasks that are a substantial part of banking, payment or investment services solely to firms that are themselves authorised by the supervisory authority to provide these services.

Thus, as recalled above, the governance rules for institutions supervised by the ACPR have been significantly changed since 2015. Five years after the implementation of these new rules, it appeared useful for the ACPR to take stock of the developments in this field and to provide supervised institutions with recommendations on how to improve their regulatory compliance.

Governance considerations and expectations

This chapter summarises the main lessons learnt by the ACPR from its supervision of institutions regarding the three main developments in governance: (i) the tightening of requirements on the role and composition of the management body in its supervisory function; (ii) the more precise definition of executive functions; and (iii) the strengthening of internal control and risk management functions in supervised institutions.

1 Composition and role of the supervisory body

Findings

Progress was noted in the organisation and functioning of the supervisory body at the majority of the institutions under review.

Most institutions were found to have expanded the composition of their supervisory body in recent years, mainly to include independent members, strengthen the body's collective competence, for example, by including members skilled in "digital" banking, or improve gender balance.

Based on the statistics in its possession (see Appendix 2), the ACPR notes in particular that:

- the proportion of members of the supervisory board without prior experience as managers or board members has decreased sharply in credit institutions and investment firms, from 88% in 2016 to 54% in 2019 for banks, and from 77% to 59% for investment firms;

- the proportion of board members holding only one mandate within entities supervised by the ACPR is also particularly high, and has increased slightly from 75% in 2016 to more than 78% in 2019 for all categories of institutions. This reflects a strong commitment on the part of board members to the fulfilment of their mandates;

- the proportion of women on the boards of directors of all entities has increased over the 2016-19 period, from 19% to 26%.

The ACPR also notes that the majority of institutions have equipped themselves with a risk committee, either by establishing an ad-hoc committee or by entrusting the audit committee with the tasks assigned to the risk committee.

These risk committees, the chair of which is most often entrusted to an independent member or one representing a minority shareholder, have significantly strengthened the supervisory body's involvement in the critical review of institutions' risk policy.

In the majority of institutions, the supervisory body's oversight and greater involvement in risk issues has also been helped by improvements in the information and documentation provided to members. Although this is not the case for all institutions, several entities have defined – or intend to define in the near term – a formal risk appetite framework setting the level and type of risks which they are prepared to incur. Moreover, the risk dashboards/summary statements communicated to the supervisory bodies are generally of high quality and likely to serve as a basis for informed exchanges.

While progress has been made in recent years, there is still room for improvement in many areas, in particular with regard to the composition and functioning of the supervisory bodies.

Recommendations

The composition of the supervisory bodies could be further enhanced in the following areas:

- The selection/recruitment/appointment process would benefit from being given a more formal structure, as none of the institutions under review had an adequate framework in this regard.

- Moreover, while most of the institutions under review provide training for new board members, in too many instances there are no provisions in place for training members over the course of their mandate, even though this might seem appropriate given the constant changes in the environment, and especially in regulations.

- Efforts to improve gender balance should be continued at all institutions under review.

- With regard to the presence of independent members on the supervisory bodies, mutual and cooperative groups are invited to develop criteria making it possible to identify members that have an equivalent degree of independence to that stipulated in the joint ESMA and EBA Guidelines. These groups should also ensure that the members thus identified are sufficient in number to guarantee the "sound and prudent management of the business".

As regards the functioning of the supervisory bodies, some progress needs to be made in communicating to members the documents to be considered and discussed in the session. In some cases, the documents are provided too late (only three days before the session, whereas an allowance of five days or even one week might seem more appropriate).

Similarly, the minutes of the supervisory body's meetings would often benefit from being made more detailed, since, at several institutions, they were found to consist merely of a summary of the decisions taken, with no reference to the exchanges of views at the meetings, or the issues that gave rise to debate.

2 A more precise definition of executive functions and of the supervisory body

Findings

In view of the prescriptive nature of banking regulations on the separation of executive and supervisory functions, the main challenge was the transition to the CRD IV regime. When the directive came into force, the ACPR identified around 130 credit institutions and investment firms headed by a CEO who was also Chairman.

A majority of these institutions decided to abandon this dual mandate by separating the two functions as soon as CRD IV came into force. The remaining institutions requested a derogation, often temporary, allowing them to continue combining the Board Chairman and CEO functions. As a result, the number of institutions with a dual CEO/Chairman mandate holder has steadily declined from 40 in 2016 to 29 in 2017, and to 18 in 2018.

Moreover, with the application of CRD IV, the ACPR also had to decide whether the legal status of simplified stock company (SAS) adopted by certain credit institutions and investment firms, was compatible with the new governance rules laid down in the directive.

In accordance with the principles set out in Position 2014-P-04, the compatibility of a credit institution or investment firm's SAS status with the governance requirements in the Monetary and Financial Code has to be assessed on a case-by-case basis by the ACPR, in accordance with the principle of proportionality. The ACPR notably examines criteria relating to the nature and scope of the entity's activity, its size in terms of outstandings, loan production and staff, and the allocation of its capital. In this respect, the ACPR stresses that institutions with a wide range of activities, which must be able to provide the widest possible range of funding or refinancing options at all times, cannot take the form of an SAS due to the constraints imposed on them regarding public offerings.

In cases where an entity's SAS status could be justified on the basis of the proportionality principle, the ACPR ensured that, to enable the statutory collegiate body to carry out its supervisory function, the Chairman in his/her supervisory function could not also be Chairman, CEO or Delegate CEO of the SAS.

Recommendations

The executive and supervisory functions should be clearly separated in order to ensure the sound and prudent management of the business.

However, under the principle of proportionality, a derogation to this requirement may be granted by the ACPR in light of the following criteria:

- the nature and variety of activities carried out: the more complex and/or diversified, the less a derogation to the principle of separation seems appropriate;
- the limited size of the balance sheet and the off-balance sheet items, not only at the date of the request but also over a medium-term horizon;
- the entity's international presence via subsidiaries, branches or the freedom to provide services;
- the number, quality and nature of the entity's shareholder structure: for example, diversified ownership or listing of part of its capital on a stock exchange normally requires a separation of functions. In contrast, a subsidiary that is nearly 100%-owned by another supervised institution, which itself applies the separation principle and exercises effective control over its subsidiary, in particular regarding internal control, may benefit from a derogation to the separation principle, provided that a review of its situation does not indicate that there are other grounds for the principle to be imposed.

Although it was contested by certain institutions, some of which had made it standard practice to allow individuals to hold dual mandates as chair of the supervisory body and effective manager, this principle of a clear separation of executive and supervisory functions was confirmed by the judgments of the Conseil d'État and European Court of Justice regarding the regional credit unions of Crédit Agricole. Moreover, in its Supervisory Manual, the ECB restricts derogations to exceptional and temporary circumstances, and identifies three types of criteria which are consistent with the position of the ACPR.

3 Internal control and risk management

Findings

While some institutions have put in place a formal risk appetite that has been approved by their supervisory bodies, this approach still needs to be implemented in many institutions.

Moreover, in those cases where a risk appetite framework does exist, it does not seem to be taken into account in other important cross-business processes, for example in the preparation of the budget, the determination of internal capital (ICAAP) or the formalisation of the preventive recovery plan. Similarly, significant strategic changes had been approved by the supervisory body without any prior or concurrent re-examination of the risk appetite.

Although relatively high quality, the dashboards/summary statements showing the evolution of risk and compliance with limits showed some room for improvement, in particular with regard to information on "qualitative" risks (non-compliance risk, legal risk, IT risk, conduct/reputation risk, etc.) which was sometimes absent or too brief. In addition, inconsistencies were found with existing limits – in some cases they were too high given the size of the institution's balance sheet or activity, and in others they were set too close to regulatory thresholds.

With regard to access to the supervisory body, in most cases it was found to be adequate for the head of the periodic review, but in some cases it was insufficient for the other heads of the control functions (ongoing supervision, risk management). For example, at one institution, the Head of Internal Control, who was also responsible for compliance checks, had only attended one supervisory body meeting in two years to present his/her work. In the same vein, the supervisory body's involvement in monitoring the implementation of corrective actions by the internal control could also be strengthened at most of the institutions under review.

Finally, at the time of publication of the present report, a very large number of supervisory bodies had not carried out a formal assessment of the governance arrangements of their institutions, even though the provisions of Article L. 511-59 of the Monetary and Financial Code impose such a review, as well as the monitoring of corrective actions to address possible shortcomings.

Similarly, the appointments committee should, in accordance with the provisions of Article L. 511-100 of the Monetary and Financial Code, “periodically and at least annually assess the knowledge, skills and experience of members of [the supervisory body],” individually and collectively, and report its findings to the latter. The institutions in question did not appear to have carried out this assessment at the time of publication of this report.

Recommendations

Where not already done, institutions shall formalise the risk appetite framework and ensure it is approved by the supervisory body.

When approving significant decisions, such as the budget, the determination of internal capital (ICAAP) or the formalisation of the preventive recovery plan, the supervisory body shall ensure that the decisions are consistent with the risk appetite framework and, where necessary, review said framework.

Institutions have a duty to improve the quality of the information submitted to the supervisory body on “qualitative” risks, such as non-compliance, legal, IT, conduct/reputation risks.

The supervisory body shall also ensure that the key function holders, such as the head of ongoing supervision or of risk management, regularly attend board meetings discussing topics within their field.

Finally, the ACPR stresses that, in accordance with Article L. 511-59 of the Monetary and Financial Code, supervisory bodies are required to carry out a formal periodical assessment of their governance arrangements and ensure that corrective measures are implemented to address possible shortcomings. For institutions that have put in place an appointments committee, the latter must periodically, and **at least once a year**, assess the knowledge, skills and experience of members of the supervisory body, both individually and collectively, in accordance with Article L. 511-100 of the Monetary and Financial Code.

Conclusion

All provisions highlighted above relate to governance organisation issues (separation of functions, composition of supervisory bodies and executive functions in particular), and to measurable criteria which constitute the necessary conditions for effective governance (competence, experience, availability, etc.).

However, governance obviously involves more than just these elements. Ultimately, the effectiveness of the management body in its executive and supervisory functions is based on the ethics, values, culture and behaviour of its members, both individually and collectively. For this reason, attention, particularly that of supervisors, is increasingly focused on these issues, which still remain difficult to examine.

Following on from the report by the Group of Thirty[4] entitled *Toward effective governance of financial institutions*, and the guidance published by the Financial Stability Board on April 2014,[5] the Basel Committee guidelines of July 2015[6] on corporate governance principles emphasise the importance of corporate values and culture.

The document proposes a definition by introducing a relationship between corporate culture and the risks taken by the bank:

4 Created in 1978, the Group of Thirty is an independent global organisation comprising high-level representatives of the public and private sectors and the academic community, *https://group30.org/publications/detail/155*

5 *Guidance on supervisory interaction with financial institutions on risk culture*, April 2014.

6 *Corporate governance principles for banks*, BCBS, July 2015.

7 "Just a few bad apples? The importance of culture and governance for good banking", speech by Andrea Enria, Chairman of the Supervisory Board of the ECB, at a Conference of the Federation of International Banks in Ireland, Dublin, 20 June 2019.

Risk culture

"A bank's norms, attitudes and behaviours related to risk awareness, risk taking and risk management and controls that shape decisions on risks. Risk culture influences the decisions of management and employees during the day-to-day activities and has an impact on the risks they assume."

One of the tasks of the Board of Directors and managers should be to bring the corporate culture, activities and behaviour of its employees into harmony with the aim of ensuring sound, prudent and integrative management that is consistent with the laws and regulations in force.

Best practices in governance are structured into 13 principles, of which 9 explicitly cite concepts of culture and values.

Corporate culture goes beyond the written rules that define corporate governance. However, good governance is a prerequisite for good corporate culture.

However, there is still room for progress at the European level. For example in banking, during the Supervisory Review and Evaluation Process (SREP) 2018 of the Single Supervisory Mechanism, around 75% of European banks scored at the bottom of the scale on governance and risk management.[7]

The supervisory body is the last line of defence in the fight against failures in decision-making. But let us not forget that there are three other lines of defence that are just as important. The first is the business lines themselves. The second is the risk management and compliance function, i.e. the people that question the decisions taken in different fields of activity, those measuring, monitoring and mitigating risks. The third and final line is the internal audit – those assessing the effectiveness of internal controls, risk management and governance. It is therefore crucial that the full effectiveness of this governance is assessed in a comprehensive manner and reviewed regularly by the supervisory body.

Remuneration is another area with a direct influence on the right incentives and corporate culture. Financial incentives are indeed extremely important for decision-making at the level of individual players.

In Europe, the rules that have been put in place since the crisis seek to support this goal by forcing banks to give more weight to long-term management.

However, these rules still leave room for institutions that do not always fulfil the expectations of supervisors.

Work in this field is therefore required, either in the context of the revision of the European regulatory framework or in the context of the work of the European supervisory authorities to harmonise practices in this field.

Appendix 1: Methodology and objectives of the review of governance

The review consisted of the analysis of extensive documentation collected from institutions subject to the French Prudential Supervision and Resolution Authority (ACPR) supervision, complemented by interviews with institutions' managers and heads of control functions, as well as members of their supervisory bodies (Chairman of the Board of Directors and/or Chairman of the Risk Committee).

In addition, representatives of the ACPR participated as observers in meetings of the supervisory bodies of supervised institutions.

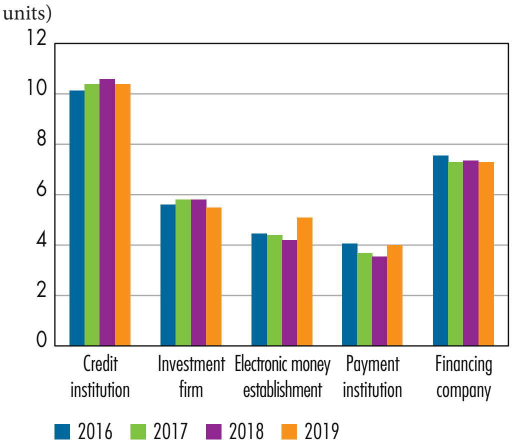
To analyse the quality of the governance arrangements in place within the banking institutions, the SGACPR teams relied on the European Central Bank's analytical grid for its "RIGA" review, built by combining the regulatory requirements introduced under CRD IV with the best practices recommended by various international fora such as the European Banking Authority, Basel Committee or Financial Stability Board. This was then adapted to take account of the specificities of the French legal framework, as well as the often smaller size of the institutions concerned, and the final grid consisted of two modules, comprising around 50 questions each, one on the composition and functioning of the governance bodies, and the other on changes in the risk appetite framework.

Following the analysis, the SGACPR provided the institutions with its findings and, after an adversarial exchange, sent them recommendations to address any identified weaknesses.

Appendix 2:
Key indicators of governance in the banking industry from information available to the ACPR

C1 AVERAGE NUMBER OF BOARD MEMBERS

(in units)



Source: French Prudential Supervision and Resolution Authority (ACPR).

T1 MAXIMUM NUMBER OF MEMBERS OF THE SUPERVISORY BOARD PER INSTITUTION TYPE

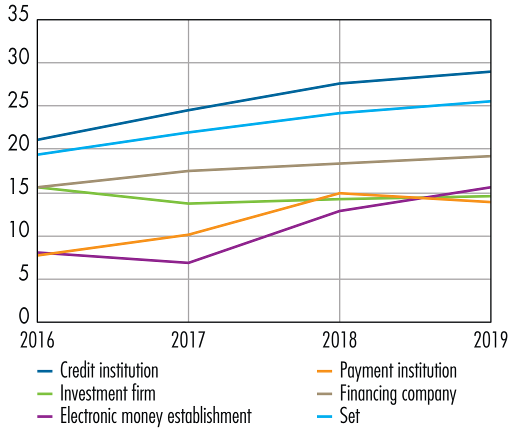
(in units)

	2016	2017	2018	2019
Credit institution	28	32	35	34
Investment firm	18	19	20	18
Electronic money establishment	6	6	6	12
Payment institution	10	10	6	7
Financing company	24	24	30	36

Source: French Prudential Supervision and Resolution Authority (ACPR).

C2 PROPORTION OF WOMEN ON THE BOARD

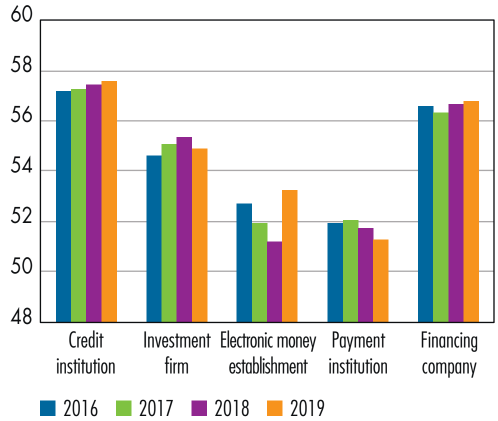
(%)



Source: French Prudential Supervision and Resolution Authority (ACPR).

C3 AVERAGE AGE OF BOARD MEMBERS

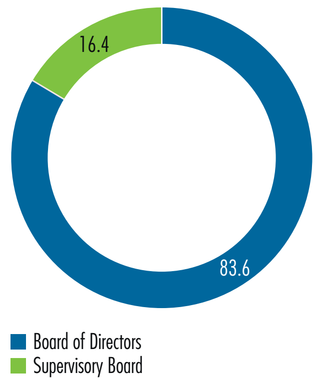
(in years)



Source: French Prudential Supervision and Resolution Authority (ACPR).

C4 BREAKDOWN OF PUBLIC LIMITED COMPANIES BY TYPE OF BOARD – 2019

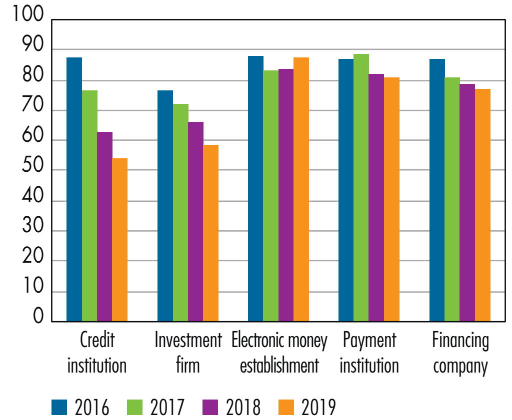
(%)



Source: French Prudential Supervision and Resolution Authority (ACPR).

C5 PROPORTION OF BOARD MEMBERS WITH NO BOARD OR EXECUTIVE MANAGEMENT EXPERIENCE IN THE FINANCIAL SECTOR

(%)



Source: French Prudential Supervision and Resolution Authority (ACPR).

T2 ACCUMULATION OF MANDATES WITHIN SUPERVISED ENTITIES BY TYPE OF INSTITUTION

(%)

	2016			2017			2018			2019		
Number of mandates	**1**	**2 to 5**	**6 and +**	**1**	**2 to 5**	**6 and +**	**1**	**2 to 5**	**6 and +**	**1**	**2 to 5**	**6 and +**
Credit institution	75	25	1	77	23	1	77	22	1	78	21	0
Investment firm	80	20	0	76	23	1	75	24	1	78	22	0
Electronic money establishment	77	23	0	77	23	0	84	16	0	85	15	0
Payment institution	94	6	0	91	9	0	86	14	0	86	14	0
Financial company	73	27	1	74	26	1	74	24	1	77	22	1
Set	**75**	**25**	**1**	**76**	**23**	**1**	**76**	**22**	**1**	**78**	**21**	**0**

Source: French Prudential Supervision and Resolution Authority (ACPR).