Corporate Governance

“Is there an Epidemic of Inexperience?”

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Is There an Epidemic of Inexperience in Corporate Governance?

- While it seems that the headlines around Silicon Valley Bank have quieted substantially, there are important factors that SVB highlighted that remain to be addressed. SVB and recent bank failures illustrate the need for effective corporate governance. Beyond the absence of a Chief Risk Officer at a critical time, the apparent lack of risk management expertise on the Board and the risk committees are concerning. Unfortunately, it appears that other large banks may also have gaps in risk expertise at the Board level and on their Risk Committees. This is particularly concerning when reflecting on key takeaways from recent failures.

What are the three most important takeaways from the recent bank failures?

1) **Recent bank failures highlighted inadequate corporate governance.** Members of Silicon Valley Bank ("SVB") and First Republic Bank ("FRB") Board of Directors' Enterprise Risk Committees ("ERC") may not have had the management experience to effectively identify and manage the risks taken by these banks. Most members' biographies reflect backgrounds that focused on potential growth opportunities for the bank but lacked enterprise risk and/or banking experience. It is critical that the Corporate Governance Committee nominate ERC Members with a broad range of risk management experience that reflects the risks taken by each bank.

2) **Investment banks and banks are highly complex enterprises.** Banks are exposed to a wide variety of risks, including credit, market, liquidity, interest rate, foreign exchange, operational, compliance, climate and cyber security risks. They are vulnerable to changes that result from regulatory and rating agency actions that may limit their business plans and create credit cliffs that can be catastrophic. The first line of defense at these companies are effective Enterprise Risk Management ("ERM") and oversight from the Board of Directors; and

3) **Risk oversight from 3rd parties does not offset inadequate corporate governance.** Regulators, rating agencies and accounting firms' responses to these financial declines and crisis significantly lagged the fast-paced market dynamics in the banking sector. They are primarily focused on financial reporting, and they are generally criteria based. Their review processes and reporting timelines result in significant delays, they lack authority to force change, and they lack accountability. Regulations are often compromises and compliance may be substituted for risk appetite.

How do the Top 15 Investment and Commercial Banks' Corporate Governance compare to SVB and FRB?

- Recognizing these gaps, Continental Insights undertook a study to see if other Banks might be exposed to similar deficiencies of risk experience in the composition of their boards. In general, the Board, the Audit Committee ("AC") and the ERC are dominated by members that have very impressive executive management experience but show a deficit in direct experience in finance and risk management that should be required for these critical oversight functions. Members need to have this experience to effectively challenge the CEO, Chief Risk Officer ("CRO") and management over risk appetite and culture. As of December 31, 2022, six of the top 15 Banks did not have ERC Members with sufficient

hands-on executive experience (at least 10 combined years) in a risk management function at Bank to effectively oversee and work with the complexity of these risks.

Comparison of the Average Years Risk Experience for ERC Members – Ranked by Experience

Top 15 Banks - BOD Executive Management Experience					
Count of Banks	Market Cap $USB	Total Assets US$T	Avg Yrs Risk Experience of ERM	Avg Yrs Finance Experience of AC	Avg Yrs Business Experience AC & ERM
5	280.7	6.5	7.8	11.7	13.2
3	275.0	8.3	4.8	9.7	16.7
7	1,120.4	15.7	0.6	8.4	19.5
15	1,676.1	30.6	3.7	9.7	17.1
SVB			0.0	5.0	22.1
FRB			0.0	1.8	18.7

Exp. Grade
Members Average Experience
15+
10 to 14.9
6 to 9.9
3 to 5.9
LT 3

Continental Insights' proprietary research using publicly available information predominantly from each company's website.

- Two Banks do not have a single member on their ERC with experience as a CRO or as an executive in a risk management function! Members on these 15 ERCs have had an average of only 3.7 years of experience in a risk related function as a CRO, a chief credit officer, an economist, a credit role, a market risk role, a sovereign risk role or financial oversight (rating agencies, accounting, regulatory or consulting) function.

- By contrast, Members on the AC have an average of 9.7 years of experience in an accounting function such as a CFO, comptroller, or a role in corporate accounting, capital management, treasury, audit function or financial oversight firms. The combined Members on the ACs and ERCs have an average of 17.1 years of experience in business leadership functions as CEO, chief operating officer, president, chief investment officer, founder or business leader and many have held leadership roles in non-Banking industries. SVB and FRB did not have an ERC Member with risk experience. This seems to demonstrate a preference for members most helpful on growth and relationship initiatives but is this to the detriment of effective risk management?

What are the primary skills and oversight needed for effective Enterprise Risk Management?

- ERMs establish and enforce the firm's risk appetite and culture; and set boundaries where risk taking behaviors and limits are unacceptable. As a regulated entity, the Board's responsibilities and requirements exceed those of companies in other sectors. The ERC and its members need to provide a high level of independence for the CRO to effectively challenge the CEO and management over risk

appetite and culture. Only two Banks have CROs that report functionally to the ERC / Board and administratively to the CEO. Most of the Banks have the CRO reporting to both the ERC and the CEO. However, five of these Banks have the CRO reporting directly to the CEO, which provides for less structural independence for the CRO, and this may create a conflict of interests.

- ERMs establish and enforce the firm's risk appetite, risk culture and boundaries where risk taking behaviors and limits are unacceptable. Risk appetite defines the type of risks and the aggregate level of risk the bank is willing to assume based on the firm's business plans and they must be consistent with applicable capital, liquidity and other risk requirements. Risk culture creates shared values, attitudes, competencies and behaviors that shape and influence governance practices and risk decisions.

- ERM roles can be very difficult to fill. Requirements include policy and process monitoring skills and the need to navigate the political bureaucracy of a highly regulated institution, requiring an ability to create low risk compromises and a "make it work for everyone" competency. The approval process and the decision makers need to adhere to the firm's risk tolerance and culture. Challenging competencies include the ability to roll up and report these risks on a firm wide basis; the ability to identify risks that are often not captured by data; navigate new risk activities lacking data and benchmarks; monitor evolving risks that exceed historical observations; and

- Incorporating all of these factors into new risk tolerances and procedures. The CRO's core competencies must reflect each firm's product and risk exposures. An expert in compliance may not be a good candidate if the financial risk to the firm is driven by credit and market risk.

What is the distinction between policy expert and practitioner?

- How do markets work? How do fundamental assumptions change when varied stresses present themselves? It is exceptionally helpful to have lived through earlier challenges, seen how things break down, mistakes made in response to unexpected developments, and how true, authentic leadership helps navigate and survive these situations. Risk professionals that have had operating, analytical, research, and internal control roles are key to ensuring all board members are appropriately informed and getting the reporting necessary to protect stakeholders. That is their duty. Growth is exceptionally important and highly desired. Having board members or an advisory firm that has been on both sides of this equation and appreciate all the plumbing (macro and micro) is essential to having a diverse and effective board in the banking sector.

It took almost 8 months after SVB's reported unrealized losses exceeding total equity before they failed! How did this happen and who is to blame?

- SVB was the 16th largest bank in the United States when it failed on March 10th, 2023. As of September 30, 2022, SVB had mark-to-market accounting of unrealized losses of $18.7 billion for securities Held-To-Maturity ("HTM") and Available-For-Sale ("AFS"). These losses exceeded SVB's total equity of $15.8 billion by $3 billion. This risk was clearly identified in SVB's 2022 10-K, stating "The Federal Reserve raised benchmark interest rates throughout 2022 and may continue to raise interest rates in response

to economic conditions, particularly inflationary pressures. Continued increases in interest rates to combat inflation or otherwise may have unpredictable effects or minimize gains on our interest rate spreads." Interest rate stress tests should have been modeled and these risks mitigated with effective risk management!

- SVB hired BlackRock's Financial Markets Advisory Group in October 2020 to analyze SVB's risks on its securities portfolio and later to examine their risk systems and processes. In January 2022, BlackRock's risk control report found that SVB lagged behind similar banks on 11 of 11 risk factors and was "substantially below" them on 10 out of 11. SVB rebuffed BlackRock's offers to do follow-up work. During this 16-month period, SVB's total assets doubled from just over $100B to over $200B; cash, cash equivalents and the AFS portfolio were reduced from 42% to 20% of total assets, while the HTM portfolio increased from 14% to 46% of total assets. This was a substantial increase in risk for SVB during the same period that BlackRock was advising SVB that they had the worst risk systems and processes compared to its peers. There is clear evidence that Management and the Board of Directors were aware of SVB's poor risk management practices.

- SVB operated without a CRO for 8 months during a critical period of rising interest rates. Without a CRO, SVB delegated authority to their ERC. However, **SVB's ERC did not have a single member with experience as a CRO or as an executive in a risk management function.** SVB failed to properly hedge its interest rate exposure, reporting interest rate hedging on its AFS portfolio declining from 91% in Q2 2021 to only 2% in Q4 2022. The HTM portfolio by Q4 2022 was over 3.5 times the size of the AFS portfolio and remained unhedged.

- In addition, there was no reporting of their asset and liability maturity profile, and no mention of a substantial increase in long-term interest-rate sensitive MBS investments.

- SVB was not a retail bank which had highly diversified deposit bases. Its deposits were primarily from venture capital, life sciences and technology companies. As a result, SVB had significant depositor concentrations which were not reported in SVB's Financial Statements, and these concentrations should have had a material impact on its liquidity needs. This basic fundamental risk was not reported by SVB management and was overlooked by its board of directors, the rating agencies, regulators and internal and external auditors.

- These issues demonstrate a failure of SVB's management, Corporate Governance, the ERC, the AC and Human Resources. Management should have identified these risks, reported them in their financial statements and to the Board, Corporate Governance should have nominated ERC members with risk management experience. The ERC did not have experience of managing the Bank's risks. Human Resources should have identified and hired a new CRO or an Interim CRO to bridge the gap in risk management expertise. The AC should have analyzed SVB's asset/liability maturity profile and concentration risks with appropriate stress tests. These are standard industry best practices for risk mitigation.

What happened to First Republic Bank?

- On May 1, 2023, First Republic Bank ("FRB") was the second largest bank to fail in U.S. history when it was closed by the California Department of Financial Protection & Innovation and the FDIC was appointed Receiver. FRB also seems to have suffered from weak corporate governance. FRB's ERC only had three members and none of them had experience in risk management or financial management functions. Their executive experience was not in financial services but primarily in health care, education and retail. FRB's ERC charter mentions oversight of the firm's CRO, but the management team did not have a CRO. They had a CCO that was "focused on safe and disciplined lending standards and practices." Who was responsible for enterprise risk management? Of the 4 Members on FRB's AC, only one member had experience in banking in an accounting management function, in addition to executive management roles.

Management and the Board of Directors were aware of its poor risk practices, can they be sued?

- From the Federal Reserves - Duties and Responsibilities of Directors, "The Board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices, whether they involve lending, investing, protecting against internal fraud, or any other banking activity. The board of directors is responsible to the bank's depositors, other creditors, and shareholders. The board of directors is responsible for establishing the policies that govern and guide the day-to-day operations of the bank, so they should review and approve them from time to time. These policies are primarily intended to ensure that the risks undertaken by the banks are prudent and are being properly managed. This means that the board of directors must, as a group, have a fundamental understanding of the various types of risks associated with different aspects of the banking business, for example, credit risk, foreign exchange risk, or interest-rate risk, and define the types of risks the bank will undertake." Without this fundamental understanding, can boards fulfill their legal obligations?

- Corporate officers and/or directors are becoming much more susceptible to being sued for actions (or lack of actions) taken in the performance of their duties. Shareholders can bring a "derivative lawsuit" alleging a breach of fiduciary duty. The duty of loyalty and good faith requires them to act in the best interest of the company and its shareholders. A breach can put them at risk for personal liability and punitive damages. The duty of care requires them to use a degree of diligence, inquiry and skill as a prudent person would use to perform their duties and they must be "reasonably" well informed in making business decisions. All business between directors or officers and the corporation must be conducted at an "arm's length" and breaches may expose them to civil or criminal liability. Directors & Officers liability insurance have limits and are not likely to cover illegal acts, even those seemingly taken on behalf of the corporation including lying to the government or regulators, being complicit in lying to the public, stealing corporate resources and embezzlement. There are several notable recent lawsuits that demonstrate some of these risks:

- A class action lawsuit was filed this year against the parent company of SVB, its CEO and its CFO, stating that the bank didn't disclose the risks that future interest rate increases would have on its business and "understated the risks posed to the company by not disclosing that likely interest rate hikes, as outlined by the Fed, had the potential to cause irrevocable damage to the company".

- A stockholder is directly suing 29 of Credit Suisse's current and former directors and officers, its four New York-based units, and its ex-auditor KPMG on behalf of a proposed class of investors. KPMG LLP and Credit Suisse Group AG's leaders are being sued for "reckless" bank management, alleging KPMG helped Credit Suisse Group AG's Directors and officers "recklessly" mismanage and "plunder" the bank for more than a decade before its collapse in March, according to a new complaint.

- On March 14, 2023, a plaintiff shareholder filed a securities class action lawsuit against Signature Bank; Joseph DePaolo, the bank's CEO; Stephen Wyremski, the bank's CFO; and Eric Howell, the bank's President and COO. The complaint was filed on behalf of investors who purchased the company's securities between March 2, 2023, and March 12, 2023. The complaint alleges that during the class period, the defendants made false and misleading statements or failed to disclose to investors that: "(1) Signature Bank did not have the strong fundamentals that it represented itself as having in the days immediately prior to the takeover, or otherwise took action that left is susceptible to a takeover by the New York Department of Financial Services (DFS); (2) as a result, it became a target for regulatory action by the DFS, and (3) as a result, Defendants' public statements were materially false and/or misleading at all relevant times."

Should Banks' Corporate Governance Committees nominate ERC Members with a broad range of risk management experience that reflects the risks taken by each bank. This will help mitigate avoidable risks including reputational risk?

- It seems given recent developments and the history of unexpected and rapid downturns for individual banking companies that in hindsight prove very avoidable, that having more risk experts on the board would be a prudent adjustment for those lacking this element in their board mix.

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