Your Job, My Job, Our Job -
the division of labour between boards and management

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Bankers are required to be suspicious. Control is second nature. Cosimo de Medici wrote a letter to his successors on his deathbed reminding them to review the accounts of the branches. German banks believe so strongly in the "four-eyes principle" that their Christmas cards come with two signatures. This is part of what makes banks unpopular – or can if they aren't unfailingly polite. An essential element in every young banker's training is learning to say "no" without saying "hell no."

The role of directors has traditionally been quite different. Serving on the board of a major bank was more an honor than a job. Customers weren't the only people a bank executive learned to charm. Since the Global Financial Crisis, much has changed. Directors are now being instructed to make "challenge" part of business as usual. Tension between board and management is seen as an *essential* feature of good governance.

Confrontation is not constructive but tension can be

I don't believe confrontation is inherently constructive. The need for it certainly varies, depending on which of its several jobs a board is doing. In that regard, I find it helpful to describe the work of a board under four headings. Moving along a spectrum from adversarial to collaborative engagement, these functions are:

- Representing the interests of shareholders vis-à-vis management;
- Establishing the rules;
- Inspecting; and
- Participating in important decisions.

The first function is at the heart of traditional governance. It starts with tasks that by definition cannot be left to management because management has its own interests to defend. Negotiating employment contracts would be a prime example. On these matters, management sits across the table from shareholders. And since face-to-face discussions are required, shareholders need someone to act for them.

Strategic decision-making can also be seen – at least in part – as a negotiation with management. For example, the potential pay-off for a chief executive from making an acquisition includes the increased prestige and compensation of running a bigger bank – not to mention the sheer excitement of "winning" a takeover battle. This can induce some chief executives to overpay, or truncate the due diligence process. Shareholders suffer when that happens. It's the board's job to temper executive enthusiasm.

A risk appetite statement is a stake in the ground

Banks as enterprises have far more down-side risk than up-side potential. That's an unavoidable consequence of being lenders. Bankers who get paid bonuses have significant up-side opportunities. They have different prospects and different incentives than shareholders do. That's why bank boards are required to produce a risk appetite statement. In doing so, they put a stake in the ground on behalf of shareholders.

A risk appetite statement is a "rule" – a word I use for anything that defines the boundaries of acceptable behavior. Other rules would include a statement of corporate values and ethical principles, the "four-eyes principle" mentioned above, position limits, credit approval processes and organizational arrangements.

One of these "arrangements" – highly recommended but not yet a binding rule – is the Three-Lines-of-Defense model mentioned earlier. Line one runs the business, deals with customers, and as the saying goes, "owns the risk." Line two includes separate risk management and compliance functions that monitor, analyze and advise. Line three is internal audit, which checks up on the other two.

Not every bank or business unit adopts Three-Lines-of-Defense in pure form. Some, for example, give all credit-granting authority to an elite group in line two and manage customer-facing bankers as a sales force – the rationale being a shortage of experienced lenders. From a bank's perspective, the decision to do this is a *risk management* choice. Many officials would regard it as a *governance* weakness. Their thinking is that unless credit skills reside in *two* parts of the bank, there will be insufficient challenge – and that good governance *requires* challenge.

A shared objective – getting it right

One of the principles of traditional governance is that a board *oversees* rather than *manages*. Both activities involve inspecting. While it is normally the boss who *inspects*, it is worth noting that both parties have the same objective: getting it right. Inspector and inspected are on the same team.

I describe the fourth function of boards as *participating* in decision-making because as a practical matter boards and managements *share* authority and the division of labor between them is unclear. To a degree, in fact, it's *intentionally* unclear.

Constitutionally, a board starts with all the power, and then delegates most of it to a chief executive. This is sensible. A board works part-time. Its knowledge is spotty. A bank needs a real chief executive. A real chief executive needs status and maneuver room. If a board insists on making too many decisions itself, it will have a hard time employing a capable chief executive – arguably its most important assignment – and anyone they appoint will get frustrated.

Effective boards typically include a few former chief executives of other companies. One reason is that such individuals' credentials give them *standing* to question management. But they also understand the pressures chief executives are under, and can offer empathy.

Empathic boards motivate managers

Empathetic boards address the challenge of keeping management motivated by making oversight as much as possible a cooperative, rather than adversarial, activity. Boards retain control of certain matters – this is the premise – not because the chief executive isn't trusted, or needs a lot of supervision, but as a way of helping management be thoughtful. "It's your decision," directors are saying, "but walk us through the analysis."

A board doesn't write a company's strategic plan. But it does have to understand it. And before *approving* the plan, directors are obliged to examine the key assumptions and evaluate the risks. A capable management will presumably enjoy that sort of interaction.

A wise board understands that successful governance requires finesse. The best relationship with management is a form of partnership. The unwritten partnership agreement provides for forthright conversations but accords respect to both parties. That's why I describe the board's fourth function as we do.

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