BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Basel Committee Guidance on Enhancing Corporate Governance for Banks

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Corporate Governance for Banks in Asia
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Outline

- **Background**
- Sound corporate governance principles for banks
- The role of supervisors
- Final thoughts

Background

- OECD has become an international standard-setter for corporate governance
- OECD issued corporate governance principles in 1999
- Basel Committee issued guidance in 1999 intended specifically for banks
- Late 1990s/early 2000s: corporate scandals
- OECD issued revised principles in 2004
- Basel Committee issued revised guidance for public consultation in July 2005
- Publication of final guidance in February 2006

Why guidance for banks?

- Critical role in the economy
- Need to safeguard depositors' funds
- Importance of trust and confidence
- High cost of bank failures
- Sensitivity to liquidity crises
- Increasing complexity of bank activities

Foundations of effective governance

- Foundations of effective corporate governance are important but may be beyond supervisory control:
  - System of business laws
  - Market integrity and transparency
  - Accounting standards
- Banking supervisors should be aware of impediments to sound corporate governance and take steps within their power to promote effective foundations

Process of developing revised guidance

- Incorporated elements of 2004 OECD principles
- Discussed lessons learned from corporate governance breakdowns
- Exchanged national guidance/legislation/regulation
- Met with industry groups and rating agencies
- Consulted with non-BCBS supervisors

Basel Committee guidance

- Applies to a wide range of banks and countries
- Applicable to diverse corporate and board structures
- Principles, not rules
- Not as prescriptive as some national legislation
- Commensurate with bank size, complexity and risk profile

2006 vs. 1999 guidance

- Introduction of “know your structure” guidance
- Expanded to consider group structures
- Protection for “whistleblowers”
- State-owned and other non-listed banks
- More in-depth discussion of:
  - Conflicts of interest
  - Role of the board of directors
  - Audit and control functions
  - Role of banking supervisors

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Sound corporate governance principles

1) Role of board of directors
2) Strategic objectives and corporate values
3) Clear lines of responsibility and accountability
4) Oversight by senior management
5) Internal/external auditors and internal control functions
6) Compensation policies and practices
7) Governing in a transparent manner
8) “Know your structure”

Principle 1: The board should…

- Understand its oversight role
- Approve business strategy, including risk management
- Avoid conflicts of interest
- Commit sufficient time and energy to fulfil responsibilities
- Develop and maintain expertise as bank grows
- Assess the effectiveness of its own governance practices

Principle 1: The board should… (cont.)

- Ensure bank has an appropriate plan for executive succession
- Receive and question information from senior management
- Provide sound and objective advice
- Not participate in day-to-day management
- Exercise due diligence in appointing external auditors

Principle 1: Independent directors

- The Board should have an adequate number of independent directors
- Independence = ability to exercise objective judgment
- Helpful if not members of bank management
- Board training programmes may be useful
- Especially important in certain areas:
  - Ensuring integrity of reporting
  - Review of related-party transactions
  - Nomination of board members and key executives
  - Board and key executive compensation

Principle 2: Strategic objectives/corporate values

- Should be established by the board of directors
- “Tone at the top” is important
- Standards should address corruption, self-dealing and other illegal, unethical or questionable behaviour
- “Whistleblowers”: Employees should be encouraged to raise concerns about illegal or unethical practices to the board or an independent committee <u>without fear of reprisal</u>

Principle 2: Watch out for…

- Lending to officers, employees or directors where allowed by national law
  - Consistent with market terms or terms offered to all employees
  - Limited to certain types of loans
  - Reports should be provided to the board
  - Subject to review by auditors and supervisors
- Preferential treatment to related parties
- Conflicts of interest

Principle 2: Addressing conflicts of interest

- Potential conflicts of interest arising from activities of the bank should be:
  - Identified
  - Prevented or appropriately managed
    - Information barriers between different units
    - Separate reporting lines and internal controls
    - Clear, fair, accurate information to customers
  - Appropriately disclosed or reported to supervisors

Principle 3: Board and senior management

- Unclear lines of responsibility can make problems worse
- The board of directors should:
  - Define authorities and key responsibilities
  - Oversee management actions
- Senior management should:
  - Delegate responsibilities to staff and promote accountability
  - Be responsible to the board for the performance of the bank

Principle 3: Accountability within groups

- Parent board and senior management:
  - Set general strategies and policies for the group
  - Determine governance structure for subsidiaries that best contributes to effective oversight
  - Be aware of risks throughout the group
  - Integrate and coordinate governance structures (e.g. to avoid undue replication)

Principle 3: Accountability within groups

- Bank board and senior management:
  - Responsible for governance of bank
  - Soundness of bank, protection of depositors, compliance with laws and regulations
  - Outsourcing of key functions (e.g. internal audit, risk management) does not eliminate bank board and senior management responsibilities
  - Responsible ultimately for corrective action

Principle 4: Senior mgmt responsibilities

- Should have necessary skills to manage business and exercise appropriate control
- Oversee line managers consistent with board policies
- Critical role: establishing system of internal controls
- Situations to avoid:
  - Inappropriate involvement in business line decisions
  - Managing areas without skills or knowledge
  - Inability to control “star” employees

Principle 5: Auditors and control functions

- Independent, competent auditors and internal control functions are vital to effective corporate governance
- Internal audit function:
  - Identifies problems with risk management and internal control systems
  - Problems should be corrected in a timely manner
  - Should report to the board or its audit committee

Principle 5: Auditors and control functions

- External auditors:
  - Ensure financial statements fairly represent financial position and performance
  - Should review internal controls related to disclosure
  - Consider periodic rotation of lead audit partner or audit firm

Principle 5: Auditors and control functions

- Recognise importance and promote throughout bank
- Auditors have duties to bank and its stakeholders
- Compliance function should monitor compliance with corporate governance regulations, codes, etc.
- Independent directors meet in the absence of bank management with external auditor and heads of internal audit, compliance, legal functions

Principle 6: Board and executive compensation

- Compensation should be consistent with long-term business objectives and strategy, corporate culture and control environment
- Should not overly depend on short-term performance
- Board (or independent committee) should approve compensation
- Policies should be clear re: trading bank stock and granting/re-pricing stock options

Principle 7: Transparent governance

- Necessary for shareholders, other stakeholders and market participants to monitor and hold accountable the board and senior management
- Need information on corporate structure and objectives
- Disclosure or reporting to supervisors is also important for non-listed banks

Principle 7: Disclosure or reporting

- Disclosure related to bank governance should be made on public website or in annual report, or should be reported to supervisors:
  - Board and senior management structure
  - Organisational structure (including ownership)
  - Incentive structure of the bank
  - Code of business conduct and/or ethics
  - Related-party transactions
- Should be proportionate to size, complexity, risk profile of the bank

Principle 8: Operational structure

- Some bank operations may lack or impair transparency
  - Particular jurisdictions (e.g. some offshore centres)
  - Complex structures (e.g. special purpose vehicles or corporate trusts)
- A bank may provide certain services or establish opaque structures for clients that also increase its risk
- Often legitimate and appropriate business purposes

Principle 8: Supervisory concerns

- The use or sale of opaque structures/products may:
  - Pose potentially significant financial, legal and reputational risks
  - Impede board and senior management oversight
  - Hinder effective banking supervision
- Risks should be appropriately assessed and managed

Principle 8: "Know your structure"

- Clear policies and procedures should be in place
  - Approval for use and sale
  - Identify and manage all material risks
- Need for such activities should be regularly assessed
- Corporate governance expectations should be established for all relevant entities
- Activities should be subject to enhanced audit procedures and internal control reviews
- Assess compliance with applicable laws, regulations and internal policies and procedures

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Supervisory role

- Supervisors are not responsible for bank performance
- Banking supervisors should:
  - Issue supervisory guidance for bank governance
  - Determine whether the bank has adopted and <u>implemented</u> sound corporate governance policies and practices
  - Assess quality of audit and control functions
  - Evaluate the effects of group structures
  - Alert board and senior management to problems

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Unique circumstances

- Controlling shareholders
  - Can be a valuable resource, but can also cause unique governance challenges because of influence
  - There should be sufficient checks and balances on inappropriate activities or influences
  - The board of directors has responsibility to the bank and all of its stakeholders
  - Supervisors should be able to assess fitness & propriety of bank owners

Unique circumstances

- State-owned banks
  - Same general principles should apply to state-owned banks
  - Should be separation of ownership and supervision functions
  - OECD guidance on state-owned enterprises

Revised Core Principles

- Q: With the new emphasis on corporate governance, why was a principle on this specific topic not included in the revisions to the Core Principles for Effective Banking Supervision?
- A: Corporate governance is a key component of many of the individual principles and, in effect, does not need a principle of its own

Revised Core Principles

- For example:
  - Principle 3: Licensing criteria
  - Principle 7: Risk management process
  - Principle 17: Internal controls and audit
  - Principle 20: Supervisory techniques
- In addition, the essential and additional criteria of all principles were reviewed and specific corporate governance references included where appropriate

Conclusions

- Banks have a unique role in the economy, so targeted corporate governance guidance is appropriate
- Key elements:
  - Board of directors = oversight
  - Senior management = internal controls
  - Supervisors = promote and assess sound governance
- Actual practice is just as important as written policies and procedures

Keeping corporate governance in perspective

- Impossible to legislate integrity
- “Independence” difficult to define
- Substance over form
- Leadership = board members and senior management as true role models

Questions or Comments?

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