



Policy Brief on Corporate Governance of Banks in Eurasia

Outline of the Policy Brief

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London
30 April 2008

The Task Force on CG of Banks in Eurasia

- The OECD and the World Bank Group promote five regional roundtables on corporate governance (CG) around the world.
 - **Eurasian Roundtable** (Roundtable) was established in 2000.
- The Roundtable identified six priorities of reform
*“Governments should intensify their efforts to improve the regulation and **corporate governance of banks.**”*
- The Roundtable launched a **task force** on bank governance
 - Experts in banking or capital market
 - Experts from Eurasia, OECD countries and international organisations
 - To develop a policy recommendations/options paper (Policy Brief)
 - OECD and EBRD serves as secretariat

What is the Policy Brief

- Nature of the Policy Brief
 - **Non-binding.** Serves as **a source of reference.**
 - No detailed prescriptions for national laws/regulations
 - May call for a fine tuning for small banks
 - Not an exhaustive textbook
 - *OECD Principles, SOE Guidelines, etc*
- Harmonisation with the **Basel Committee's work**
Enhancing Corporate Governance for Banking Organisations
- Developed in the **Eurasian context**
- Would assist wide range of people;
 - Policy makers, banking supervisors, banking associations, capital market regulators, stock exchanges and, last but not least, banks

Why is bank governance so important?

- It is essential to sound & proper functioning of banks (i.e. deposit taking, credit allocation and payment)
 - For instance, bank failure might
 - involve systemic risks
 - cause huge negative impact on depositors, other stakeholders and economy as a whole
 - lose people's confidence in banks
 - Discussion on bank governance needs special consideration on depositors
- In Eurasia, banking is the most advanced industry. Banks' governance can be a role model for other companies

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Chapter 1. Boards, board members and board committees (1/3)

- Boards are crucially important
- **Independent directors** (IDs), not just non-executive directors (see Annex)

(A) Independence from **senior management**

For instance

- No former senior management (including mgt. board)
- No former employment
- No additional remuneration
- No material business relationship (including external audit)
- No close family ties to the people above

(B) Independence from **controlling shareholders**

Chapter 1. Boards, board members and board committees (2/3)

- Independent directors (Cont.)
 - **Positive criteria (attributes)** to complement the negative criteria for IDs
 - e.g. professional backgrounds, integrity and healthy scepticism
 - Bank boards should have a sufficient number of IDs
 - Specific roles should be allocated for IDs
 - e.g. **chair, lead non-executive director**
 - Chairperson from former mgt. board member is not recommendable

Chapter 1. Boards, board members and board committees (3/3)

- Board member's qualification
 - **Collective** knowledge as an entire board. Some members should have a sufficient knowledge of banking on appointment
 - Trainings including CG awareness-raising program
- Boards' specialised committees
 - Board **audit committee** is recommended. "*Revision Commission*" cannot substitute for board audit committees
 - Other committees are also important
 - **Nomination committee, risk management committee**
 - Rather than formalities, what matters more is that bank has effective, **well-functioning** committees

Chapter 2. Strategic objectives and professional conduct, etc. (1/2)

- Strategic objectives & other guiding policy documents
 - In approving/reviewing them, the supervisory board should be able to receive necessary **support from the management board**
- Compliance oriented bank culture
 - **The board** is responsible for nurturing sound bank cultures
 - By awareness-raising programs, incentive schemes, analysing failures, becoming a role model, and developing code of conduct
 - Banks should make public their compliance structure and activities
 - Employees should be **encouraged** to communicate their concerns
 - **Procedures** (including confidential direct access) should be specified
 - **Protection** should be secured

Chapter 2. Strategic objectives and professional conduct, etc. (2/2)

- How to prevent abusive **RPTs** (Related Party Transactions)
 - Basel Committee’s guidance
 - RPTs should be made on arm’s length basis
 - Materially important ones need the **board’s prior approval**, to be disclosed and reported to supervisor
 - Board’s prior approval...avoid “Rubber Stamping”
 - Never approve RPTs unless **clear proof** is presented to show that they are on arm’s length basis
 - Boards’ **specialised committees**
 - An option: **Outright banning** of some limited types of RPTs

Chapter 3. Clear lines of responsibilities and accountability

Clear, **not multiple** lines

- The board (supervisory board) should occupy superior position over senior management (the management board)
- The supervisory board should have power in relation to **appointment & removal** of the management board
 - The supervisory board should be encouraged to nominate candidates for the management board

Chapter 4 Oversight by senior management and internal control functions

- Internal control
 - Started with reducing fraud, misappropriation and errors
 - Becomes more extensive, **addressing all risks**
Credit risks, market risk, interest rate risk, liquidity risk, operational risk, etc.
- Who should do, and what to do?
 - In varying degrees, **everyone**'s responsibility in banks
 - **Senior management** should establish, monitor and improve it
 - **Boards** should ensure that senior management does so
- **“Four Eyes Principle”** as an integral part of daily operations

Chapter 5 Internal audit and external auditors (1/2)

- Internal audit should have **appropriate status to have senior management react** on its findings.
- Are “**Revision Commissions**” working effectively?
 - ✓ Statutory bodies other than the boards
 - ✓ Responsibilities in relation to internal audit and supervision
 - ✓ Appointed at general shareholder meetings, not by the boards
 - ✓ Mostly report directly to general shareholder meetings
- “Revision Commissions” cannot substitute for board audit committees. It is suggested to make it **optional** for banks to **replace** them by creating **board audit committees**.

Chapter 5 Internal audit and external auditors (2/2)

- External auditors
 - **Rotation** of audit engagement team (if not the audit firm).
 - Limitation on non-audit work
 - Effective sanctions to **dissuade** unprofessional behaviour
- External auditors and banking supervisors
 - They have **complementary** concerns. But the focus of their concerns is **different**. The normal relationship between auditors and their clients should be **safeguarded**.
 - legal basis for banking supervisors to **hear the views** of auditors
 - Legal obligation to report material **breach** of laws to banking supervisors
 - Legal protection or **immunity** when they report
 - Banking supervisors should reject and rescind inappropriate auditors

Chapter 6. Compensation

- Extraordinary **low** remuneration for bank boards (supervisory boards) is not desirable
 - Extraordinary low remuneration may be signalling the board's ineffectiveness
- Banking supervisors or banking associations may want to provide **guidance** on compensation
 - Based on the guidance, banks are encouraged to develop their own remuneration policy

Chapter 7. Transparency and disclosure in terms of CG

- Ensuring appropriate public disclosure is important
 - Market discipline
 - Harmonisation to **internationally recognised standards** on accounting (e.g. IFRS) and auditing (e.g. ISA)
- Among governance-related disclosure items, information on **ownership structure** is crucial.
 - Not only record ownership but also **beneficial ownership** (i.e. real owner)
- **Co-operation** between banking & capital market supervisors
 - Information sharing and harmonisation of disclosure requirements

Chapter 8. Corporate Governance of SOCBs (1/2)

- **State-Owned/Controlled Commercial Banks (SOCBs)**
 - ✓ State's significant control including significant minority ownership
 - ✓ Either direct or indirect ownership
 - ✓ Either listed or non-listed
 - ✓ Commercial banks (not Development Banks)
- SOCBs face some **unique or more accurate** governance challenges than other banks
- OECD's *SOE Guidelines*: The state should;
 - Make SOCBs have **professional, effective & independent boards**
 - **Utilise the boards** to effectively supervise management while reflecting from day-to-day intervention

Chapter 8. Corporate Governance of SOCBs (2/2)

- The state should NOT
 - become passive, **indifferent owner**
 - Developing **ownership policy** is recommended
 - Prioritised, clear objectives
 - The state's role in CG of the SOCB
 - How to implement the ownership policy
 - intervene in **day-to-day management**
 - Utilise the boards to supervise management
- SOCBs need **external audit (besides state audit)**
 - State should exchange views with external auditors
- SOCBs can become role models in improving CG

Chapter 9. Banks' monitoring of the CG practices of their corporate borrowers

- What roles are Eurasian banks expected to play?
 - Banks play significant roles in Eurasia. Market discipline via securities market is not yet sufficient.
- Banks' **assessment & monitoring** on corporate **borrower's** CG should be encouraged (as an important part of risk management)
 - Will benefit banks themselves as far as the borrower's CG affects its credit worthiness
 - **Policy tool** to improve national CG standards
- But banks' arbitrary intervention is not desirable
 - Banks' request on corporate borrowers' CG should be specified in **covenants, depending on the borrowers size.**

Chapter 10. The role of supervisors and the next steps

- Regulators should promote good governance in which **banks would naturally pursue sound banking**
 - Effective banking supervision is important, but it is **not a panacea**.
 - Monitor whether banks really implement good CG policies or not
- Appropriate **combination** of Hard Law (laws and regulations) and Soft Law (e.g. voluntary codes)
 - CG Cods on **“complain or explain”** basis
- Banking supervisors should take a leadership role to develop a **national CG code for banks**
 - Developing a **template** based on which banks would develop their own CG codes, respectively



Empower the board (1/5)

- The boards (supervisory boards) should play a critically important role in bank governance.
- “*Together with **guiding** corporate strategy, the boards are chiefly responsible for **monitoring** managerial performance and achieving an adequate return for shareholders, while **preventing** conflicts of interest and **balancing** competing demands of relevant stakeholders*” (OECD Principles).

Empower the board (2/5)

Effective boards need **information**

- [Para #23] **Support** from senior management (the mgt. board)
- [Para #16] **Chair** of the board should ensure that board members (IDs, especially) obtain necessary info.
- [Footnote #17] **Company secretary**
- [Para #36] **Internal auditors** should have a reporting line to the board
- [Para #39] The board should exchange views with **external auditors**
- [Para #25] Encouraging employees to report **concerns** about unlawful conduct



Empower the board (3/5)

Effective board needs **capability**

- [Para #17] **collective** knowledge and **individual** expertise on banking
- [Para #17] Board **training** program
- [Para # 15] **Positive** criteria (attributes) for IDs
- [Para #18-22] Board specialised **committees** for small group intensive discussion and deep analysis backed by expertise
- [Para #41&42] Board members need adequate **remuneration**



Empower the board (4/5)

Effective board need **independence**

- [Para #14 & Annex] Independence from **management**
- [Para #14 & Annex] Independence from **controlling shareholders**
- [Para #15] **Positive** criteria (attributes) for IDs
- [Para #16] Specific **roles** to be allocated for IDs
- [Para #19] **Audit committees** should be composed in a way that IDs can exert influence on decisions

Empower the board (5/5)

Effective board needs **power within the bank**

- [Para #30] Supervisory board should at least propose **appointments/removals** of management board members at general shareholder meeting even if laws provide shareholders with the appointments/removals power.
- [Para #37] “Revision Commissions” may be **diluting** board’s responsibility and power



Hard Law & Soft Law

- appropriate balance - (1/5)

- Banking supervision has traditionally been based on laws and regulations (**Hard Law**) covering a wide range of subjects.
- More **Effective & precise** regulations (especially prudential oversight of capital, liquidity & risk mgt.) is increasingly need.
- Nevertheless, **direct** regulations & supervisions are not a panacea.

Hard Law & Soft Law

- appropriate balance - (2/5)

- For instance,
Basel II: Besides the minimum regulatory capital ratios (pillar 1. traditional approach), there are two new pillars to accompany it.
 - **Pillar 2: Efforts by banks** to assess their capital adequacy and by supervisors to review such assessment (supervisory review)
 - **Pillar 3: Banks' public disclosures** that lend greater insight into their capital adequacy (market discipline)
- More **emphasis** is needed on good bank **governance** in which banks are expected to pursue sound banking.



Hard Law & Soft Law

- appropriate balance - (3/5)

- **Best practice** regarding corporate governance
 - Besides laws & regulations (**Hard law**), voluntary codes & principles (**Soft Law**) play important roles.
 - **Appropriate combination** between Hard Law & Soft Law (Exact combination may differ country by country)

- Some items are often included in **Hard Law**

For instance,

 - Fundamentals (e.g. mandatory/optional one-tier or two tier board structure, key functions of the boards, etc.)
 - Needs binding force (e.g. board's fiduciary duties, key disclosure items)

Hard Law & Soft Law

- appropriate balance - (4/5)

- Why do many countries use **Soft Law** as well?
 - For instance,
 - One-size-fits-all is often **not** effective for CG issues
 - Easy to revise, **flexible** for ever-changing circumstances, and allows **experimentation** & innovation
 - Allows **principles-based** approach. No “*show me where it says we cannot do it*” mentality
 - Less regulatory **costs**
 - Allows **bottom-up, pragmatic** approach and **process**
- Voluntary governance codes with “**comply or explain**” basis are recommended

Hard Law & Soft Law

- appropriate balance - (5/5)

- **“Comply or explain”** codes
 - As purely voluntary, private sector recommendations
 - As stock exchange rules/guidelines/recommendations (e.g. **listing requirements**)
 - Developed by, or by the **support/initiative** of, governmental agencies
 - With some **legal backing** (e.g. Company Law refers to the codes)
- Governance codes specifically applied to **banks**
 - Based on which an **individual bank** can develop its own codes/policies



Thank you very much.

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