The governance of banks in transition economies
Bosnia and Herzegovina country report

January 2012
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**Foreword**

1. In July 2010, the Legal Transition Team of the EBRD launched a comparative assessment of the corporate governance of banks in its countries of operations. The overall objective of the assessment is to inform and support the EBRD’s policy dialogue with authorities with a view to generating further commitment to improve the corporate governance of banks in EBRD countries of operations. The assessment aims at providing the EBRD with an overview of the legal and regulatory framework governing the corporate governance of banks and how diligently the various rules and best practice guidelines are implemented.

2. The assessment focuses mostly on internal corporate governance arrangements in banks, particularly the role and composition of boards. It analyses the legal and regulatory framework; its implementation by supervisors; and the practices developed by the systemically important banks in each country. The transparency of governance arrangements to the supervisory authority and the markets is also reviewed. While the assessment analyses banks and their boards, and considers ownership structure and patterns in the banking sector, broader governance issues covered in the OECD Principles such as shareholder and stakeholder rights and responsibilities as well as equity market issues are not dealt with in any detail.

3. To enhance the EBRD’s understanding of the corporate governance of banks in countries of operations, countries reviewed are subjectively rated. For this purpose, the legal framework, supervisory practice and banking practice are given an overall score in the overall assessment section of each Country Report. The rating approach is detailed in the box below.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 – “<strong>strong to very strong</strong>” - The corporate governance framework / practices of supervisory authorities / practices of banks are fit for purpose and are close to best practice.</td>
<td></td>
</tr>
<tr>
<td>3 – “<strong>moderately strong</strong>” - Most parts of the corporate governance framework / practices of supervisory authorities / practices of banks are adequate but further reform is needed</td>
<td></td>
</tr>
<tr>
<td>2 – “<strong>weak</strong>” - The corporate governance framework / practices of supervisory authorities / practices of banks contain some elements of good practice but overall the system is in need of reform</td>
<td></td>
</tr>
<tr>
<td>1 – “<strong>very weak</strong>” - The corporate governance framework / practices of supervisory authorities / practices of banks contain significant risks and are in need of significant reform</td>
<td></td>
</tr>
</tbody>
</table>

4. Each Brief Country Report is divided in two Sections: (A) Methodology and overview of the banking system; (B) Key findings – describing the strengths and weaknesses of the corporate governance of banks and policy recommendations where appropriate.

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1 The assigned rating will be confirmed at the end of the assessment, once all countries have been assessed.
Methodology and overview of the banking system in Bosnia and Herzegovina

1) Methodology

5. Bosnia and Herzegovina ('BiH') comprises two entities: the Federation of Bosnia and Herzegovina ('FBH') and the Republika Srpska ('RS'). The report analyse the legal framework and practices in both entities: the FBH and the RS, with a primarily focus on the FBH.

6. The analysis and recommendations contained in this report are based on research carried out by the EBRD and responses to written questionnaires sent to one FBH law firm; the Central Bank of Bosnia and Herzegovina ('CBBH'); the Banking Agency of Federation of Bosnia and Herzegovina ('FBA'); and four large banks in the country ('the banks reviewed'). Responses to the questionnaires were complemented by a desk research of FBH legislative framework, information from banks reviewed websites and their 2010 annual reports, and other information on banking sector available from on-line sources.

7. The report occasionally comprises conclusions about RS legal framework and local practice, which are based on on-line sources and responses to the questionnaire by the Banking Agency of Republika Srpska ('BARS').

8. Note that the legal framework in many aspects is identical in both entities, as a result most of the conclusions included in the report regarding legal framework are equally relevant for both entities FBH and RS, unless stated otherwise.

9. The banking sector in Bosnia (with 29 operative banks) is fairly concentrated: the Top-3 players (UniCredit, Raiffeisen and Hypo Alpe Adria Group) together control more than 50% of the market. The only M&A activity in 2011 involved the take-over of the local franchise of Volksbank International by Sberbank, which is among the Top-10 players on the local market.

Exhibit 1: The largest five banks, by market share

<table>
<thead>
<tr>
<th>Bank name</th>
<th>Market Share (%)</th>
<th>Listing on SE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Unicredit Group*</td>
<td>19.4</td>
<td>none</td>
</tr>
<tr>
<td>2. Raiffeisen Bank d.d.</td>
<td>18.5</td>
<td>none</td>
</tr>
<tr>
<td>3. Hypo Alpe Adria Group</td>
<td>13.4</td>
<td>none</td>
</tr>
<tr>
<td>4. NLB Group</td>
<td>9.3</td>
<td>none</td>
</tr>
<tr>
<td>5. Intesa Banka</td>
<td>6.1</td>
<td>none</td>
</tr>
<tr>
<td><strong>Total 5 largest banks</strong></td>
<td><strong>66.7</strong></td>
<td></td>
</tr>
</tbody>
</table>


*UniCredit Bank & UniCredit Bank Banja Luka Source: CBBH, Raiffeisen RESEARCH
2) **Overview of the banking sector in Bosnia and Herzegovina**

10. The Dayton-Paris peace agreement ended the 1992-95 war. At the same time, the complex Dayton constitutional set up has generated a fragmented policy-making apparatus in BiH. The major challenge remains constitutional reform, without which further progress towards a more efficient state, implementation of a comprehensive reform agenda and EU approximation will be difficult to achieve. This process is sensitive and may take time.

11. According to the EBRD Strategy for BiH, after several years of robust growth, as a result of the economic crisis, BiH economy entered a sharp decline in late-2008 - in common with other countries of the region - and output fell significantly in 2009. The authorities have taken some commendable steps to preserve macroeconomic stability. The currency board remains the key anchor of macroeconomic policy and the annual inflation rate fell to below zero in late-2009. The central bank took prompt action to preserve confidence in banks at the height of the crisis and played an active role in securing a “Vienna Initiative” agreement among the six largest foreign-owned banks to maintain their exposure in BiH. Confidence in banks has also been enhanced by a significant increase in the deposit insurance limit.

**Federation of Bosnia and Herzegovina**

12. According to the FBA, at the end of 2011, there were 19 banks with banking license issued in the FBH. The number of banks declined in comparison to 2009, since the license of UNA bank d.d. Bihac was revoked in 2010. Other two banks are under provisional administration (Hercegovačka banka d.d. Mostar and Postanska banka BH d.d. Sarajevo).

<table>
<thead>
<tr>
<th>Type of financial institution</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>20</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Branches of foreign credit institutions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cooperative banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Banking sector, total:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: BSCEE Review 2011*

13. Banks must be established as joint-stock companies organised under a **two-tier system**: the general meeting of shareholders ('GMS') appoints the supervisory board ('SB') and the SB appoints the management board ('MB'). Banks are required to set up an audit board ('AB'), which does not include board members and is appointed and supervised by the supervisory board. The same structure applies in RS.

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3 Information on the banking system of the Federation of Bosnia and Herzegovina as of 31.12.2010, FBA, published in March 2011, see at: [http://www.fba.ba/images/Publikacije_Banke/Informacija_bank_31122010_eng.pdf](http://www.fba.ba/images/Publikacije_Banke/Informacija_bank_31122010_eng.pdf)

14. The aggregate balance sheet of the banking sector, as of the end 2011, amounted to KM 15.2 bn (approx. 7.75 bn Euro), representing an increase by 1% compared to the previous year. Net capital of banks in the FBH, as well as regulatory capital, increased by 3% on the previous year and at the end of 2011 amounted to KM 2.1 bn (approx. 1.07 bn Euro). Capital adequacy rate of the banking system, as of the end of 2011, was 17.1%, which is still much more than the minimum prescribed by the law (12%), representing satisfactory capitalization of the entire system very strong basis and foundation to preserve its safety and stability.

15. According to the 2011 BSCEE Report, the nominal value of the GDP for FBH in 2011 was KM 25.95 bn (approx. 13.23 bn Euro) which represents a nominal increase of 5.6%, compared to 2010. The performance of the banking sector of the FBH in 2011, as in the previous two years, was under the impact of the global economic crisis and recession. Some positive changes in the first half of year slowed down due to the events in the euro zone, the escalation of the debt crises, which also had an effect on the slowing down of the economic growth and the deterioration in the macroeconomic conditions in BiH.

![Exhibit 3: Asset portfolio quality of the banking sector (share of impaired receivables/share of NPLs)](image)

<table>
<thead>
<tr>
<th>Asset classification</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non financial sector</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- households</td>
<td>39.2</td>
<td>43.6</td>
<td>69.61</td>
</tr>
<tr>
<td>- corporate</td>
<td>35.2</td>
<td>39.0</td>
<td>71.70</td>
</tr>
</tbody>
</table>

Source: BSCEE Review 2011

16. As a consequence of the indirect impact of the crises on real sector, in banking sector there has been a deterioration of the loan portfolio and increase of the reserve expenses for loan losses, which had a significant impact on the downfall of the profitability of all banks.

17. The FBA reports that at the end of 2010, ownership structure in banks comprised 18 privately owned banks (market share - 99%) and one state owned bank (1%). Seven of the 18 banks with private ownership, are majority owned by domestic legal entities and individuals (Residents), while 11 banks have majority foreign ownership. At the end of 2010, banks with majority foreign ownership held 91.9% of market share (2% decrease compared to 2009); whereas banks with majority domestic private capital held 7.0% of market, and the share of banks with majority state capital was 1.1%.

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5 Based on exchange rate, by CBBH, as of 28.11.2011: 1 KM (CM/BAM) = 1.96 EUR  
6 Banking Supervisors from Central and Eastern Europe
Republika Srpska

18. According to the Banking Agency of RS ('BARS'), at the end of 2011 the banking sector of the Republika Srpska had a total of 10 banks with majority private capital, dominated by foreign private capital. The number of banks did not change since 2007.

19. In the course of 2011, the RS economy started getting out of recession and the economic movements were more dynamic than in the two preceding years, therefore trend of economic recovery after the 2009 recession may be said to have continued. The positive dynamic that started 2010 was maintained in the first half of the year, however, it slowed down in the second half of the year due to a number of internal and external factors negatively affected growth.\(^7\)

20. The total balance sheet amount was KM 6.64 bn with growth rate of 11% if compared to 2010. Share of NPLs (loans classified into higher risk categories) in the total loan portfolio

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\(^8\) BSCEE Review 2011.
decreased from 17.14% to 11.46%. The NPLs level calls for an additional attention and prudence. Positive trend of capital strengthening in RS banks in 2011, and growth of capital planned in 2012 should be a guarantor of keeping RS banking sector secure.

Exhibit 6: Asset portfolio quality of the banking sector (share of impaired receivables)

<table>
<thead>
<tr>
<th>Asset classification</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>- households</td>
<td>37.4</td>
<td>53.4</td>
<td>60.5</td>
</tr>
<tr>
<td>- corporate</td>
<td>28.0</td>
<td>45.8</td>
<td>52.3</td>
</tr>
</tbody>
</table>

Source: BSCEE Review 2011

21. In 2011, a dominant position in the foreign ownership in the RS banking sector was kept by Austria having a share of 42.53% (in 2010 it was 46.69%) and majority capital in three banks. Owners from Slovenia, Serbia, Lithuania, and US each owned one bank. One bank with majority foreign ownership had a significant share of shareholders from the Netherlands (36%). Two banks with majority domestic ownership increased their share in the total equity from 18.02% (as of 31.12.2010) to 19.10%. The majority foreign owned banks in RS have a share of 95.3% of assets and deposits, and 92.4% of share in capital. Domestically owned banks occupy the remaining part.⁹

22. The **Central Bank of Bosnia and Herzegovina** ("CBBH" or "Central Bank") operates in both entities, FBH and RS. The CBBH has only limited responsibilities in regard of banking sector. It assists the Banking Agencies of each entity in bank licensing and supervision. Otherwise, the Central Bank is responsible for deciding and supervising the monetary policy.

23. The **Banking Agency of the Federation of Bosnia and Herzegovina** ("FBA") is the supervisor for the banking sector in the Federation of Bosnia and Herzegovina. The FBA issues bank licences, approves banks’ management, gathers information on banks, supervises banks, applies sanctions and banks have to report to the FBA. The FBA also supervises micro-credit organisations. The scope of FBA’s activity is limited to the FBH and does not include RS.

24. The **Banking Agency of Republika Srpska** ("BARS") was established in 1998 as a legal successor of the National Bank of Republika Srpska with a goal of “maintaining a sound and stable banking system of RS, and improving its safe, high quality and legal operation”. The main
tasks of the BARS include: i) issuing and revoking bank licenses; ii) on-site and off-site bank supervision; iii) managing and supervising bank rehabilitation and liquidation process; and iv) issuing bank regulations.

25. Each entity has its own stock exchange: Sarajevo Stock Exchange (FBH)\(^\text{10}\) and Banja Luka Stock Exchange (RS)\(^\text{11}\). None of the banks reviewed in FBH is listed with the Sarajevo Stock Exchange.

26. All three largest banks in Republika Srpska are listed with the Banja Luka Stock Exchange: Hypo Alpe-Adria-Bank a.d. Banja Luka, NLB Razvojna banka a.d. Banja Luka and Nova banka a.d. Banja Luka.\(^\text{12}\) The market capitalisation of the stock exchange at the end of 2010 was BAM 3.7 bn (appx. EUR 1.8 bn) and the turnover was BAM 176 mln (appx. EUR 90 mln).\(^\text{13}\) The stock exchange publishes all annual and semi-annual reports about the registered banks, as well as issuers' announcements.\(^\text{14}\)

*Laws and regulations relevant for corporate governance of banks*

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**Exhibit 8: Laws and regulation on the corporate governance of banks**

**Laws**

**Federation of Bosnia and Herzegovina\(^\text{15}\)**

- **Law on Banks** (1998) – it regulates the establishment, business operation, governance, supervision and liquidation of legal entities that engage in the business of receiving money deposits and extending credits in the Federation of Bosnia and Herzegovina.
- **Law on Banking Agency of the Federation of Bosnia and Herzegovina** (1996) – it sets the scope and method of work for the FBA.
- **Law on Central Bank of BiH** (1997) – it sets the scope and method of work for the CBBH.
- **Law on Enterprises** (1999) – it describes the establishment, governance structure, operation and liquidation of enterprises in FBH.
- **Law on Accounting and Audit in the FBH** (2009) – it sets accounting and audit principles for FBH companies, indicates responsible bodies and their qualifications.

**Republika Srpska\(^\text{16}\)**

- **The RS Law on Banks** (2003) – it governs the establishment, business operation, governance, supervision and termination of legal persons who engage in the business of receiving money deposits and extending credits in RS.
- **The Law on Banking Agency of Republika Srpska** (1998) – it establishes the Agency and regulates its operations, powers and responsibilities.
- **Law on Companies** (2009) – it establishes rules for the establishment, governance structure, operation and liquidation of enterprises in RS.

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11 Banja Luka SE, see at: [http://www.biberza.com/v2/Pages/default.aspx](http://www.biberza.com/v2/Pages/default.aspx)
16 See RS laws at: [http://www.abrs.ba/propisi/propisi_eng.htm](http://www.abrs.ba/propisi/propisi_eng.htm)
Secondary Acts

**Federation of Bosnia and Herzegovina**

- **Decision on Minimum Standards for Risk Concentration Management in Banks** (2002).
- **Decision on Minimum Standards for Bank’s Liquidity Risk Management** (2002) - it determines minimum standards that a bank is obliged to ensure and maintain in the process of managing liquidity risk in order to create and implement liquidity policy, which assures bank’s capability to fully and without any delay perform its liabilities at maturity date.
- **Decision on Financial Disclosure** (2002) – it determines the criteria for filling out the financial disclosure statement by the supervisory board members, senior executives and their closest relatives, and method and deadlines for filing.
- **Guidelines on Licensing and other approvals issued by the banking agency of the Federation of BiH** (2002) – it includes mandatory rules that define licensing and basis for other approvals issued by the FBA in relation to performance of banking activities, as well as basis for rejecting applications for issuance of licenses and approvals and for revoking licenses and approvals.

**Republika Srpska**

- **Decision on Minimum Standards for Banks’ Capital Management** (2003) – it defines the minimum standards of capital and minimum standards for creating and implementing the Program for managing capital, which a bank is obliged to provide and to maintain and implement on continuous basis.
- **Decision on Minimum Standards for Banks’ Credit Risk Management and Assets Classification** (2003).
- **Decision on Minimum Standards for Banks’ Risk Concentration Management** (2003).
- **Decision on Banks’ Operation with Related Persons** (2003).
- **Decision on Minimum Standards for Banks’ Internal Control Function** (2003).
- **Decision on Minimum Standards for Banks’ Internal and External Audit Function** (2003).
- **Guidelines on licensing and other approvals by BARS** (2003).

**Corporate Governance specific regulations:**

**Federation of Bosnia and Herzegovina**

- **Joint-Stock Company Governance Regulations** (2006) – it sets forth the standards of governing a joint stock company that relate to the appointment and dismissal of the stock company’s bodies, duties and responsibilities of these bodies and their members in the managing procedures of the stock company, management of business operations of the stock company and rights and duties of shareholders and other interested parties in the stock company. It appears that the

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18 See RS banking regulations at: [http://www.abrs.ba/propisi/propisi_eng.htm](http://www.abrs.ba/propisi/propisi_eng.htm)
Regulation is mandatory for all joint-stock companies, as all banks are.

**Republika Srpska**

- The Standards of Corporate Governance, (2006)\(^1\) – it details the governance rules for joint stock companies, rights of the shareholders and responsibilities of governing bodies. The Standards are intended primarily for joint stock companies whose shares are traded on the stock exchange or other regulated public market. It appears the Standards apply on a “comply” or “explain” rule, if provisions contain words such as: “may”, “should”, i.e. companies must explain if they do not comply with the rules prescribed by the Standards. The other provisions in the Standards are mandatory and reflective of provisions contained in laws and regulations. The standards are posted on the Banja Luka Stock Exchange and there is also a Scorecard that assists in calculation of the degree of compliance of a company with the corporate governance code. All three largest banks in RS appear to be registered with the SE. However, none of the banks publish a completed Scorecard or any other declaration of compliance with the Standards.

Key findings

3) The strategic and governance role of the board

Key strengths

Federation of Bosnia and Herzegovina

27. The Federation of Bosnia and Herzegovina (FBH) has developed the main legal tools necessary for regulating corporate governance of banks. Banks must be organised under two-tier governance system appointing separate supervisory and management boards. The banking law attributes to the supervisory board a clear oversight role as the board appoints the management board and supervises its activity. All banks reviewed confirmed that their supervisory boards appoint the management of the bank and set their performance targets.

28. The Entity has adopted the Joint-Stock Companies Corporate Governance Regulation (CG Regulation) that details the governance framework for joint-stock companies including banks. The CG Regulation puts the supervisory board in charge of monitoring and insuring the effectiveness of the corporation’s governance structure. Further, the banking law encourages supervisory board to adopt a code of ethics for the bank and the management.

29. Accordingly, the banks reviewed indicated that the supervisory board is in charge of adopting governance policies of the bank. In all respondent banks supervisory boards have adopted codes of ethics. This allows supervisory boards to set the "tone at the top" in terms of conduct rules and actively participate in shaping the governance system of the bank. The respondent law firm is of the opinion that banks' governance systems include a dedicated officer or department that monitors compliance with the code of ethics/conduct. It seems that in practice these codes are well communicated within the banking organisations.

30. The FBA monitors banks' governance structure and approves banks’ charters. The FBA reports to have the authority to address corporate governance failures and compel appropriate remedial action. These include setting a timetable for compliance and deciding on sanctions for non-compliance. However, the FBA indicated that such powers are rarely used.

31. From a bank governance perspective, the FBH banking system has also benefited from the dominant presence of European banking groups. There is the feeling that this presence has accelerated the transfer to the FBH banking system of good practices developed by well established banking groups and implemented by experienced bankers and sophisticated supervisors.

Republika Srpska

32. Republika Srpska has textually identical banking law to that of the FBH. In contrast, though, the RS has recently adopted a new company law that is more precise on the strategic role of the supervisory board in companies and explicitly delegates the approval of company strategy and business plan to the board. Moreover, the new company law requires companies to adopt a code of conduct or adhere to the national code of corporate governance. This may be interpreted to confer a more obvious mandatory nature to the Standards on Corporate
Governance, which are currently primarily of recommendation nature. The largest banks in the country do not follow suit yet as none publishes governance reports or explain any digresses from the Standards.

Key weaknesses

Federation of Bosnia and Herzegovina

33. The banking law and company regulations do not clearly delegate the responsibility to approve bank budget and business strategy to the supervisory board or to any other governance body. This may seem to offer a higher degree of flexibility allowing banks to decide freely on such delegation, but in practice may undermine the board’s strategic responsibility to decide the bank’s development path and the way resources are deployed to achieve strategic objectives. Because most large banks are subsidiaries of foreign banking groups, this may lead to a higher risk of the subsidiary board becoming a mere formality with all the strategic decisions being dictated by the parent/group. On the other hand, the bank practice does not yet raise concerns and all banks reviewed indicated that their boards approve the multi-year strategy. In the majority of the banks reviewed the board is in charge of approving the budget.

34. In a group setting, there is always a risk that a subsidiary boards may be viewed as mere formality, instances that exist only to justify the “fiction” of the separate legal entity. But it is wrong to view subsidiary boards as devoid of any organisational value. From a group’s perspective a subsidiary board is a very useful “hub” of local accountability, bringing together the oversight of all functions and business lines at local level. The board provides a “mini big picture” of the subsidiary, which helps to avoid vertical silos across the group. When it comes to controls, local boards are a very useful additional buffer, another line of defence, to prevent lapses and failures at local level. From a forward looking strategic perspective, they are also a useful way to provide an out-of-the-box perspective on local threats and opportunities which might often elude both local and group executives. Finally, from a regulatory perspective, subsidiary boards ensure that institutions, especially the systemically important ones, are focused in preserving the stability and effectiveness of the local banking system even in the few cases where these priorities might not be aligned with the broader interests of a multinational corporate group.

35. The risk of overlooking the local interests is further emphasized by the fact that in the majority of banks reviewed there are no local nationals sitting on the supervisory board. The legal framework does not require banks to have local experience and knowledge represented at the board. This risk is to a certain extent attenuated by the fact that the FBA meets annually with the representatives of the group and requires banks to approve policies specifying the role of the parent entity in decision-making in specific business and functional areas.

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20 The EBA Guidelines on Internal Governance recommend the board of the subsidiary to adhere to the same governance values as its parent, unless legal or supervisory requirements or proportionality considerations determine otherwise. Accordingly, the board of a subsidiary should, within its own internal governance responsibilities, set its policies and should evaluate any group-level decisions or practices to ensure that they do not put the subsidiary in breach of applicable legal and regulatory provisions or prudential rules. The board of the subsidiary should ensure that such decisions or practices are not detrimental to: (a) the sound and prudent management of the subsidiary; (b) the financial health of the subsidiary; or (c) the legal interest of the subsidiary’s stakeholders.
36. As mentioned above, local banks do not publish "comply or explain" reports as required by the Standards on Corporate Governance, or include a statement on corporate governance in their annual reports. The Standards primarily apply to joint stock companies that trade on organised markets. Since the three largest banks in RS are registered with the Banja Luka Stock Exchange, the Standards apply to these banks. The local supervisory authority should encourage banks to adhere to the Standards.

4) Composition and functioning of the board

Key strengths

Federation of Bosnia and Herzegovina

37. The banking law and CG Regulation adequately detail the duties of loyalty and care for supervisory and management board members requiring boards to undertake their duties conscientiously, with loyalty and in the best interests of shareholders. The CG Regulations require board members to avoid engaging in competitive activities with the bank, attend and actively participate in board meetings. The banking law also includes relevant sanctions, including payment of damages. Note, though, that there have been no court cases to reveal how application of such rules fares in practice.

38. The company law limits the size of the supervisory board to seven members. In most banks reviewed the board comprises five members (see Exhibit 9 below). Smaller boards are generally better equipped to efficiently discharge their duties and allow adequate participation to all members.21

21 "The board should structure itself in a way, including in terms of size, frequency of meetings and the use of committees, so as to promote efficiency, sufficiently deep review of matters, and robust, critical challenge and discussion of issues." Basel Committee’s Principles for enhancing corporate governance - final document, 2010, § 42, see at: http://www.bis.org/publ/bcbs176.pdf. According to the UK Corporate Governance Code "The board should not be so large as to be unwieldy and should be of sufficient size that the requirements of the business can be met and that changes to the board’s composition and that of its committees can be managed without undue disruption", Section B, B1; see at: http://www.frc.org.uk/documents/pagmanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf. Further, in the Walker Review of corporate governance in banks in UK it is stated that based on most recent research and behavioural studies that "an “ideal” size [for a bank board is] of 10-12 members, not least on the basis that a larger board is less manageable, however talented the chairman, and that larger size inevitably inhibits the ability of individual directors to contribute”, § 3.1, see at: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.
39. In all banks reviewed, the supervisory boards meet regularly, at least once per quarter as required by law. The company law requires banks to appoint a corporate secretary, senior executive, who is in charge of coordinating general meetings of shareholders, supervisory and management board meetings and monitor implementation of their decisions. It is not clear if the secretary is also in charge of overseeing compliance with governance rules.

40. Banks do not seem to set up board committees. Two respondent banks have created risk committees (see Exhibit 10 below), which include SB members and executives. There are no independent directors. Given the concentrated typical ownership structure of banks in the country, the absence of remuneration or nomination committees is not necessarily an issue.

41. Despite the lack of clear guidance in the law regarding the composition of the supervisory boards, the boards of the four banks reviewed are staffed with senior executives from banking groups with relevant financial industry expertise. In this respect, the presence of group senior executives on the boards of subsidiaries can ensure effective lines of communication between...
the subsidiary and the parent. The **chairs of the boards** appear to have sufficient executive skills and banking experience. The adequate presence of skills on bank boards must contribute to boards being able to discuss the growing in complexity banking industry issues and challenge management decisions.

42. There is a strong approval regime for **management board members**, with fit and proper requirements covering the probity of directors as well as directors’ competence and experience. These requirements are very carefully checked by the FBA, which approves all management board members, and has the power to reject appointments.

43. There are no legal requirements for banks to provide **induction and/or training** to board members, but banks seem to have taken the initiative and three out of four banks reviewed reported that they have induction and training programmes for their directors.

**Republika Srpska**

44. The new **RS Law on Companies**, encourages SBs to set up board committees for purposes of focusing on certain areas of business. Additionally, the **RS Standards on Corporate Governance** recommend that the supervisory boards establish separate committees that are competent to conduct qualified, expert, independent and professional analyses of concrete problems, hence increasing the efficiency of its own operations.

45. The **RS Standards on Corporate Governance** recommend that SB members should adequately understand operations of the company and possess necessary abilities, skills, knowledge and competences required for carrying out their duties.

46. Additionally, the Standards recommend that audit board members have the necessary moral qualities and dedicate sufficient time for adequate discharge of their duties. The members should have adequate experience and knowledge in the field of finance, accounting and audit standards. The chair of the audit board should not have been a member of the management board of the bank within the previous 5 years. Note that the Standards are intended primarily for joint stock companies whose shares are traded in the stock exchange or other regulated public market. All three largest banks in RS appear to be registered with the stock exchange. However, none of the banks publish a completed scorecard or any other declaration of compliance with the Standards.

**Key weaknesses**

**Federation of Bosnia and Herzegovina**

47. The **fit and proper tests for the supervisory board** members established by the law do not include experience and financial soundness. It appears that the FBA must approve the candidates for the supervisory board but the prerequisite criteria are of general nature. The SB candidate must have no economic criminal record, not be restricted from management activities, not sit on the management board of another bank in FBH, not be an elected official, and, curiously if not discriminatorily, not be older than 70 years old. Despite lack of legal requirements towards experience of board members, banks' practice shows a tendency to include experienced bankers on their supervisory boards, which saves the day. This should not be taken for granted and the policy makers and the FBA should consider including experience...
requirements in law or regulations to ensure that supervisory boards in banks possess the necessary skills. Ideally, the board should possess, both as individual board members and collectively, appropriate mix of skills, competencies and personal qualities in line with the bank’s strategy and risk appetite and adequate for the board’s oversight responsibilities. These might include: finance, accounting, lending, bank operations and payment systems, strategic planning, communications, governance, risk management, internal controls, bank regulation, auditing and compliance.  

48. The legal framework does not require banks to include independent directors on their supervisory or audit boards and, obviously it does not include a definition of independent directors. As a consequence, in all banks reviewed, all members of the supervisory boards are connected to bank controlling shareholders. It is important that boards have the ability to exercise objective judgment independent of both the views of executives and of inappropriate political or personal interests, including controlling shareholders. Emerging supervisory expectations within the EU recommend the appointment of independent directors in subsidiaries boards to assist the board in ensuring that group-level decisions are not detrimental to the sound and prudent management of the subsidiary, the financial health of the subsidiary and the legal interests of the subsidiary’s stakeholders.

49. Banks are required by law to set up an audit board ('AB'), which must not include any directors or senior executives and be comprised of five members appointed by the supervisory board. Accordingly, all banks under review have set up such boards. The audit board is responsible for overseeing the external audit firm, bank financial statements and all internal audit activities. The decision about the qualification of the audit board members is entirely left at the discretion of the banks, as the FBA does not monitor audit board composition and the law does not establish qualification requirements. In view of the responsibilities of the audit board and best practices, it is advisable that members of an audit board as a whole have recent and relevant practical experience in the area of financial markets and at least one member or, ideally, the chair should have specialist knowledge and experience in the application of accounting principles and internal control processes. The members of the audit board are vaguely required to have no direct or indirect financial interest in the bank.

50. The practice of separate audit boards including "outsiders" instead of audit committees made of (independent) supervisory board members needs to be carefully assessed. The key question here is what could a person that it is not a board member add to the debate? The discussion is open. First, we would argue that the audit board should include only board members if the functions delegated to the audit board are typical board functions. According to current FBH legislation the final responsibility for the internal control system resides with the supervisory board, which also appoints and dismisses the head of internal audit department. Secondly, it is essential that those members sitting in the audit board and recommending specific actions to the supervisory board, then follow up and vote the recommendations at the supervisory board, therefore reinforcing the “objective judgement”

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25 The arguments in favour of this approach are that non-board members would allow the audit committee to draw from a larger pool of industry and accounting expertise and that it might give the audit committee greater independence.
that independent directors (which typically sit on board committees) should have. Finally, this structure can create problems with confidentiality and accountability issues. While it is legitimate that the committee might need external advice or expertise on specific issues, it should be able to request such advice, but it should not allow the advisor(s) to replace the committee in its determinations and recommendations.

51. The law does not require banks to perform board evaluations, but boards must submit activity reports to the general meeting of shareholders (i.e., the group). Based on the analysis of the responses to our questionnaires, the respondents perceive such reports as self-evaluations. However, it is not clear if this reporting contributes to address weaknesses in the board composition and functioning or is merely an activity report for shareholders information.

Republika Srpska

52. In RS, the CG Standards recommend supervisory boards to include a majority of independent directors. However, it is not clear how banks comply with this recommendation, as they do not publish any corporate governance compliance reports. The Standards include a definition of impartiality of supervisory board members.

53. Surprisingly, the banking law provision regarding the size of the SB (identical to the one in the FBH law) was interpreted to indicate that SB cannot include more than five members. As a result, the three largest banks in RS have SBs comprising five members.

54. Another issue of concern in bank practice in RS is that, according to BARS, the supervisory boards of banks meet usually more than twelve times per year. Such frequency of board meetings may be indicative of SB dealing with operational matters of the bank, which should be the responsibility of senior management. The law requires SB to meet at least four times a year and does not indicate that banks have operational responsibilities in bank activity.

5) Risk Governance

Key strengths

55. The banking law and a number of banking regulations dealing with various types of risks ascribe to the supervisory board explicit responsibility for overseeing the implementation of the risk management system and ensuring that the management board comply with approved policies and procedures. By law, banks’ supervisory boards are also responsible for monitoring the risk profile of their banks.

56. Accordingly, the supervisory boards of all four banks reviewed regularly monitor the risk profile of their banks. Responses to questionnaires indicate that they receive quarterly reports on the risk profile in all key risk areas and are regularly informed of concentration ratios in specific geographic areas and sectors. Similarly, the supervisory authority quarterly reviews bank’s risk profiles.
57. The legal framework requires banks to set up a separate risk function and all banks reviewed reported to have created such risk departments. The risk departments report directly to the management board, but also must submit regular reports to the supervisory board.

58. Banking law does not require banks to create risk committees at supervisory or management board level, leaving this decision at the discretion of the banks. At the same time based on responses to questionnaires, the majority of the banks reviewed have set up senior executive risk committees, having an integrated view of all categories of risks and responsibility for the overall risk profile of the bank. All banks have also established ALCO and Credit Committees and a few other executive committees. Although, two banks reviewed reported to have created risk committees at the supervisory board level, only in one bank this committee comprises a majority of SB members.

59. The law and banking regulations do not require banks to appoint an independent chief risk officer (CRO) with direct access to the SB. Notwithstanding this, all four banks reviewed reported to have appointed chief risk officers reporting directly to the CEO and the FBA confirmed that it monitors the presence of the CRO and the extent of its responsibilities as part of the supervisory process. Three of the banks reviewed indicated that their CROs have direct access to the supervisory boards, which is key to insure the independence of the risk function.

Key weaknesses

60. Banking regulation does not currently require boards to adopt a forward looking statement on risk (i.e., risk appetite). The supervisory authority confirmed that it does not require banks to approve and submit such statements. Despite this, all respondent banks have indicated that their boards do approve risk appetite, but based on the answers to questionnaires and review of the banks’ annual reports, we suspect that the risk appetite approved by the supervisory board is more akin to strategy rather than the definition of high level boundaries for credit and market risk. In our view, it is a key strategic responsibility of the supervisory board to formulate the bank’s risk appetite, which should serve to provide clear top-down guidance to risk originators within the bank’s management as to how far they can go in using the bank’s capital within a determined period of time.

61. The legal framework should provide on the role of an independent chief risk officer (CRO). The CRO (or equivalent) should be able to communicate directly with the management board concerning adverse developments that may not be consistent with the institution’s risk

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26 “Risk reporting systems should be dynamic, comprehensive and accurate, and should draw on a range of underlying assumptions. Risk monitoring and reporting should occur not only at the disaggregated level (including risk residing in subsidiaries that could be considered significant), but should also be aggregated upward to allow for a firm-wide or consolidated picture of risk exposures. In this regard, organisational “silos” can impede effective sharing of information across a bank and can result in decisions being made in isolation from the rest of the bank. Overcoming information-sharing obstacles posed by silo structures may require the board and senior management to review or rethink established practices in order to encourage greater communication. Some firms have found it useful to create risk management committees - distinct from the board’s risk committee - that draw members from across the firm (e.g., from business lines and the risk management function) to discuss issues related to firm-wide risks.”, Basel Committee on Banking Supervision, Principles for enhancing corporate governance (2010), §§ 97-98, see at: http://www.bis.org/publ/bcbs176.pdf

27 For further guidance about board responsibilities see Basel Committee on Banking Supervision, Principles for enhancing corporate governance (2010), Principle1, page 7-8.
appetite and tolerance and business strategy and be able to report directly to the supervisory board or, where appropriate, to the audit committee (or equivalent).  

6) Internal Control

Key strengths

Federation of Bosnia and Herzegovina

62. The regulatory framework on internal control is mostly contained in the banking law and in the Decision on Minimum Standards for Internal Control in Banks (“the Decision”). These acts explicitly assign to the supervisory board the responsibility for establishing an efficient control system in their banks which includes clear authorities and responsibilities of key functions and precise separation of operational and control functions. Accordingly, all banks reviewed confirmed that they have approved organisational charts, have clearly documented terms of references for all key functions and decision-making authorities and there is a segregation of duties in their banks.

63. The supervisory authority confirmed that it carefully monitors banks' internal control systems and requires regular reports about the effectiveness of the system. The FBA reviews the segregation of duties in banks and the internal audit function.

64. The legal framework requires banks to appoint an independent internal auditor. Such internal auditor must have direct access to the supervisory board and is appointed by the SB. The Decision stresses the unrestricted and unimpeded authority of the auditor thus backing its stature within the bank, which is essential for its controlling functions.

65. All banks reviewed have set up a separate and independent internal audit department that assesses the effectiveness of internal control system, establishes and implements an audit plan, issues recommendations and verifies compliance with such recommendations. All banks require internal auditors to coordinate their work with external auditors. The supervisory authority actively supervises the independence of the internal audit function. Internal audit functions in the four banks reviewed seem to be sufficiently integrated with the group’s internal audit functions. Responses to questionnaires reveal that in all banks reviewed the group’s internal audit function audits the subsidiary’s internal audit and appoints or recommends the appointment of the subsidiary’s internal auditors, providing an additional guarantee of their independence from the business.

66. The law explicitly ascribes the responsibility for the accuracy of financial reporting to the supervisory and management boards. The financial statements published by the banks on-line are undersigned by the CEO and the chief accountant officer. Banks include a statement of responsibility of the MB and SB for the financial reports in their annual reports.

67. With regard to related party transactions, the banking law and CG regulation establish a comprehensive framework, providing a definition of related parties and requiring independent

review of such transactions, as well as requiring banks to adopt specific conflicts of interests policies. The SB and MB members and persons related to them must disclose information and submit formal statements about their assets, investments and debts to the bank and to the supervisory authority (FBA). All banks reviewed reported to have approved specific policies for managing conflicts of interests, including related party transactions. All banks reviewed include a disclosure statement about related party transactions in their annual reports. The respondents expressed the view that related party transactions occur under transparent conditions.

68. Despite lack of guidance in the banking legal framework, all banks reviewed reported that they have set up compliance functions to assist with compliance and regulatory risks. The supervisory authority believes that the compliance function in banks has sufficient resources, expertise and authority. The regulator monitors whether banks establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with their regulatory obligations.

**Republika Srpska**

69. The RS legal framework regarding internal control system is similar to that of the FBH, revealing the same strengths. Additionally, the RS Standards on Corporate Governance prohibit companies (the Standards use mandatory language in this provision) to engage an external auditor who provides consultancy services for the company or in case where more than 30% of the audit firm’s income is realized from such company, except in its first year of operation. The Standards apply to all three largest banks in the Entity and the RS Banking Agency believes that external auditors do not provide non-audit services in RS.

**Key weaknesses**

**Federation of Bosnia and Herzegovina**

70. As discussed above in § 49 and 50, the structure, composition and qualifications of the audit board and the lack of independent directors on the supervisory board may threaten the efficiency and independence of the internal control function in banks.

71. Since banking regulations do not include any guidance in relation to the audit department in banks, it is not clear if the provisions regarding the stature and independence of the internal auditor, mentioned in § 64, apply to the internal audit department employees. As all banks have created audit departments it is important that the legal framework confers necessary resources and authority to the bank’s audit department.  

72. The law does not require banks to set up a compliance function and does not provide any guidance to this end. This may increase the risk for inconsistent practice among banks with some banks potentially choosing not to create such function or cause the compliance function in banks to gravitate only on anti-money laundering issues, as is often the case in the region. In international practice, the compliance function is in charge for managing the compliance

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29 For guidance see EBA Guidelines on Internal Governance (GL 44), 2011, page 43-44.
risk,\(^{30}\) which can lead to fines, damages and/or the voiding of contracts and can diminish a bank’s reputation.\(^{31}\) The function should identify related potential risks, as well as material deviations, and report these to board and the management.

73. The legal framework does not appear to uphold the independence of the external auditor. There are no requirements to insure that the external auditor is in no conflict of interest with the bank and there is no obligation to rotate external auditors. The respondents indicated that external auditors do provide non-audit services to banks, but the supervisory authority does not require banks to approve policies regarding provision of non-audit services. Accordingly, the bank practice varies, as half of banks reviewed rotate their external auditors and three out of four banks reviewed do not have policies for managing the provision of non-audit services by the external auditors.\(^{32}\)

**Republika Srpska**

74. The RS legal framework regarding internal control system is similar to that of the FBH, revealing the same weaknesses, except as mentioned in § 46 and 69.

7) **Incentives and Remuneration**

**Key strengths**

**Federation of Bosnia and Herzegovina**

75. According to the company law, the supervisory board is responsible for determining and approving the remuneration of the management board. In this respect, all banks reviewed confirmed that their boards approve formal remuneration policies and reported that the remuneration structure of the bank is linked to firm and individual performance. The variable part of executive compensation does not exceed 20% of the remuneration package.

76. Although, not required by law, all banks reviewed disclose in their annual reports the aggregate amounts of remuneration paid to their governance bodies. Only one bank itemises the payments and indicates the amount of bonus paid, as well as other variables of the compensation.

**Republika Srpska**

77. The RS Standards on Corporate Governance include a number of recommendations regarding compensation for the supervisory and management boards which explicitly enumerate such factors as: company’s business performance, its financial results, scope of competences of each board member and their functions, and the level of board remuneration in comparable

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\(^{30}\) See in particular, EBA Guidelines on Internal Governance (GL 44), page 43. Compliance risk is defined as the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, rules, regulations, agreements, prescribed practices or ethical standards) can lead to fines, damages and/or the voiding of contracts and can diminish a bank’s reputation.

\(^{31}\) See EBA’s Guidelines on Internal Governance (GL44)


companies operating on the market. Standards also urge companies to disclose their remuneration policies and amounts paid. The Standards apply to all three largest banks in the RS as they trade their shares on the local stock exchange. These banks publish an aggregate figure of the payments to the banks' governing bodies.

**Key weaknesses**

78. The legal framework, including the *JSC Governance Regulation*, contains no guidance regarding bank compensation policies and in particular the link between compensation and prudent risk management. Moreover, the supervisory board's role as regards compensation policies for the entire bank is unclear.  

79. As a consequence, it seems the CRO is paid based on the same criteria as the senior executives. This practice should be avoided. According to best international practices "for employees in the risk and compliance function, remuneration should be determined independently of other business areas (...) performance measures should be based principally on the achievement of the objectives of their functions."  

80. Responses to questionnaires indicate that the supervisory authority seems to have limited awareness of the banks' compensation practices.

**8) Transparency to the market and regulators**

**Key strengths**

*Federation of Bosnia and Herzegovina*

81. Financial reporting in accordance with full IFRS is required for all financial institutions and banking regulation requires regular audit of financial statements.  

82. The legal framework establishes that each bank must publish the external auditor's annual report, names of members of the SB and MB and indicate shareholders owning 5% or more of shares with voting rights. The banks must also publish announcements about general meetings of shareholders and the meeting agenda. However, the law requires that such disclosure is made in newspapers without requiring bank’s website publication.  

83. In practice, banks publish on-line their audited annual reports. Other information available on banks' websites and in their annual reports include ownership structure, composition of the supervisory and management boards, related parties transactions, organisational structure, risk management policies statements, aggregate amounts paid to the management and occasionally to SB.

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33 "The board should actively oversee the compensation system’s design and operation, and should monitor and review the compensation system to ensure that it operates as intended.", Principle 10, Basel Committee on Banking Supervision, Principles for enhancing corporate governance (2010).

34 Compensation Principles and Standards Assessment Methodology, Basel, 2010, Principle 3 - Standard 2, see at: [http://www.bis.org/publ/bcbs166.pdf](http://www.bis.org/publ/bcbs166.pdf)
84. Responses to questionnaires and interviews indicate that information filed with the FBA each year includes at least an operating and financial review, a report on ownership structure, a report on effectiveness of internal controls. At the same time, the supervisor reported that it has full access to banks’ books and records and is able to obtain information about the banks’ ultimate ownership.

Republika Srpska

85. The RS Standards on Corporate Governance include a separate chapter on disclosure of information. It concentrates on mandatory disclosure of information to shareholders and inter alia includes: governance structure of the company, related party transactions, risk management processes, and rights attached to securities issued. The Standards delegate the duty to oversee compliance with the disclosure requirements to the supervisory board.

86. The three largest banks in RS disclose the same information as FBH banks, (i.e. ownership structure, composition of the supervisory and management board, related parties transactions, organisational structure, risk management policies statements, aggregate amounts paid to the governing bodies). Additionally, RS banks disclose the names of the audit board members and occasionally bios for the management board members. The Banja Luka Stock Exchange publishes for all three largest banks their annual and semi-annual reports, agenda and decisions of the general meetings of shareholders, occasionally, decisions of the SB, as well as other announcements by the registered banks.

Key weaknesses

Federation of Bosnia and Herzegovina

87. The disclosure requirements are limited, as banks are not required and do not publish the structure of their boards, terms of reference of the governing bodies (SB, MB and AB), experience of the members of the governance bodies, risk governance structure, itemised directors’ remuneration reports (aggregate indication of the variable and deferred parts of compensation) and rights of the shareholders.

88. Responses to questionnaires indicate that the banks do not file with the FBA a report on risk along the lines required by Pillar III of the Basel II framework, which would enable a better assessment of their risk profile and their capital adequacy. It seems that banks do not file annual corporate governance reports (i.e. information about SB, AB and MB meetings and work during the year) or director remuneration reports.  

Republika Srpska

89. The RS legal framework regarding disclosure of information is similar to that of FBH with the exception of the provisions in the RS Standards on Corporate Governance, mentioned above. The banks in RS similarly to those in FBH do not publish information about the structure of their boards, terms of reference of the governing bodies (SB, MB and AB), experience of the members of the governance bodies, risk governance structure, itemised directors’

35 For more information see: Basel Committee on Banking Supervision, Principles for enhancing corporate governance (2010), §§ 134-141.
remuneration reports. However, there is more information available to shareholders and the public about general shareholders meetings and decisions, bank announcements and occasionally activity of the SB, due to disclosures published on the stock exchange.

9) **Key recommendations**

90. The following box includes recommendations, which aim to address some of the weaknesses identified in this Report. As explained in Section 1, the recommendations refer only to the FBH, as the team had access to more information about FBH framework and was able to evaluate more accurately its strengths and weaknesses.

<table>
<thead>
<tr>
<th><strong>Legal framework</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The banking law should clearly assign the responsibility to approve the bank’s budget and strategy to the supervisory board of banks.</td>
</tr>
<tr>
<td>2. At least for the systemically important banks, banking regulation should require the presence of one supervisory board member with local expertise, who is independent from the group.</td>
</tr>
<tr>
<td>3. The law and banking regulations should establish &quot;fit and proper&quot; criteria for the supervisory board members, which should include banking/financial and risk management experience appropriate for the size, business and strategy of the bank.</td>
</tr>
<tr>
<td>4. The audit board composition should be re-considered to see if the presence of outsiders makes the body effective. The legislator should also consider on whether it is appropriate for the audit board to become a proper board committee and include [a majority of] independent supervisory board directors. The audit board as a whole should have recent and relevant practical experience in the area of financial markets and at least one member, ideally the chair, should have specialist knowledge and experience in the application of accounting principles and internal control processes.</td>
</tr>
<tr>
<td>5. The law should provide guidance to banks regarding appointment of a CRO or equivalent senior function responsible for the risk management across the bank and for coordinating the activities of other units relating to the bank’s risk management framework and have direct access to the SB and its independent directors.</td>
</tr>
<tr>
<td>6. The banking regulations should provide a definition of risk appetite and require at least systemically important banks to produce an annual statement on their risk appetite. Subsidiaries should be required to align the group’s risk appetite with the sound and prudent management of the subsidiary. The supervisor should review banks’ risk appetite statements.</td>
</tr>
</tbody>
</table>
7. The banking regulations should provide guidance regarding independent audit department and compliance function to insure their independence and authority within the bank.

8. The legal framework should include provisions to insure the independence of the external auditor, and in particular it should require banks to have specific policies on provision of non-audit services by the external auditors.

9. The banking regulation should require banks to disclose information about the structure and composition of board committees, responsibilities of the board and its committees, and experience of supervisory, management and audit boards' members. Banks should be required to disclose such information on their websites.

Supervisory practice

10. The supervisory authority should approve the candidates for banks' audit boards as part of the appointment process.

11. The supervisory authority should monitor the supervisory boards' involvement in setting bank-wide compensation policies and the alignment of compensation with prudent risk management. The FBA should be able to access the quantum and structure of key senior executives, including heads of control functions.

12. The supervisory authority should require banks to file a report on risk along the lines required by Basel II, Pillar III enabling a better assessment of their risk profile and their capital adequacy, as well as annual corporate governance reports.

Bank practice

13. Banks' boards should carry out regular assessments of both the board as a whole and of individual board members.
10) **Overall assessment of bank governance quality in FBH**

91. The following table provides a preliminary rating of FBH’s performance in the key governance areas mapped out in the EBRD best practice assessment checklist. Rating in this table is subjective and based on the overall assessment of the strengths and weaknesses of the legal framework, supervisory practice and the practice of banks as discussed above. The rating also reflects our assessment of the legal framework, supervisory practice and the practice of banks compared to international best practice standards.36

<table>
<thead>
<tr>
<th>Issues</th>
<th>Score 1 to 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The strategic and governance role of the board</strong></td>
<td></td>
</tr>
<tr>
<td>Strategic role of the board</td>
<td></td>
</tr>
<tr>
<td>Do boards have a sufficiently active role in developing and approving the strategic objectives and the budget of their banks?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do boards effectively review and evaluate management performance against agreed budgetary targets?</td>
<td>Strong (4)</td>
</tr>
<tr>
<td>Do boards effectively shape the governance framework and corporate values throughout their organisation?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Are boards of subsidiaries in a position to effectively control the operation of their banks?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Is there adequate transfer of good practice between parents and subsidiaries?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td><strong>Board composition and functioning</strong></td>
<td></td>
</tr>
<tr>
<td>Size, composition and qualification</td>
<td></td>
</tr>
<tr>
<td>Is the size of boards adequate to meet the requirements of their business?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Are directors qualified for their position?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Is the board sufficiently independent from management and controlling shareholders?</td>
<td>Very Weak (1)</td>
</tr>
<tr>
<td>Are the duties of directors to their banks, shareholders and stakeholders clearly set out?</td>
<td>Moderately Strong (3)</td>
</tr>
</tbody>
</table>

36 Best practice standards used in our assessment:

37 Where:
4 – “strong to very strong” - The corporate governance framework / practices of supervisory authorities / practices of banks are fit for purpose and are close to best practice.
3 – “moderately strong” - Most parts of the corporate governance framework / practices of supervisory authorities / practices of banks are adequate but further reform is needed
2 – “weak” - The corporate governance framework / practices of supervisory authorities / practices of banks contain some elements of good practice but overall the system is in need of reform
1 – “very weak” - The corporate governance framework / practices of supervisory authorities / practices of banks contain significant risks and are in need of significant reform.
<table>
<thead>
<tr>
<th>Issues</th>
<th>Score 1 to 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is there adequate balance of power between individuals within boards and are there adequate checks to maintain the balance?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do board chairs possess relevant banking and/or financial industry experience and a track record of successful leadership?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Do current tenure patterns of board directors suggest a high level of engagement and independence?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do boards provide adequate induction and professional development to their members?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Nomination committees</td>
<td></td>
</tr>
<tr>
<td>Is the process for director succession and nomination sufficiently transparent?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Functioning and evaluation</td>
<td></td>
</tr>
<tr>
<td>Are the responsibilities, authorities, and terms of reference of boards and board committees clearly defined and documented?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Do boards function in ways that encourage informed contribution and constructive challenge by all directors?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do boards meet regularly?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Are boards and board committees supported by a senior company secretary?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Do boards evaluate their performance and discuss the outcome of such evaluation?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Risk governance</td>
<td></td>
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<tr>
<td>Risk governance framework</td>
<td></td>
</tr>
<tr>
<td>Are boards and their risk committees sufficiently involved in setting the risk appetite and monitoring the risk profile of banks?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do banks appoint and empower senior chief risk officers?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do senior executives have a sufficiently integrated firm-wide perspective on risk?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Risk committees</td>
<td></td>
</tr>
<tr>
<td>Are boards in a position to effectively review risk management?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Internal Control</td>
<td></td>
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<tr>
<td>Internal control framework</td>
<td></td>
</tr>
<tr>
<td>Does the organisational structure of banks include clearly defined and segregated duties for key officers and effective delegation of authority?</td>
<td>Strong (4)</td>
</tr>
<tr>
<td>Are there enough checks and balances to ensure the independence and integrity of financial reporting?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Are conflicts of interest including related party transactions effectively managed?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Have banks established effective internal audit departments?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Do banks establish effective compliance departments to ensure that they comply with regulatory obligations?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do boards and their audit committees effectively oversee and regularly review the effectiveness of the internal control systems?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td>Issues</td>
<td>Score 1 to 4</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>--------------</td>
</tr>
<tr>
<td><strong>Audit committee</strong></td>
<td></td>
</tr>
<tr>
<td>Do boards establish audit committees?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Are audit committees fully independent?</td>
<td>Very Weak (1)</td>
</tr>
<tr>
<td>Do audit committees include at least one member with substantial auditing or accounting experience?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td><strong>Incentives and compensation</strong></td>
<td></td>
</tr>
<tr>
<td>Remuneration policy</td>
<td></td>
</tr>
<tr>
<td>Do boards and their remuneration committees have a sufficient role in shaping the compensation system of their banks?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Is remuneration meritocratic and linked to firm and individual performance?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Is senior executive compensation aligned with prudent risk management?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td><strong>Remuneration committee</strong></td>
<td></td>
</tr>
<tr>
<td>Do boards establish remuneration committees?</td>
<td>n/a</td>
</tr>
<tr>
<td>Are remuneration committees independent from management?</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Transparency to the market and regulators</strong></td>
<td></td>
</tr>
<tr>
<td>External auditor</td>
<td></td>
</tr>
<tr>
<td>Is external auditor independence upheld by boards and their audit committees?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Financial statements</td>
<td></td>
</tr>
<tr>
<td>Is IFRS required by law or regulation?</td>
<td>Moderately Strong (3)</td>
</tr>
<tr>
<td><strong>Corporate governance</strong></td>
<td></td>
</tr>
<tr>
<td>Do banks report regularly on corporate governance matters?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Do banks publish key governance information on their website?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td>Is disclosure proportionate to size, complexity, ownership structure and risk profile of banks?</td>
<td>Weak (2)</td>
</tr>
<tr>
<td><strong>Transparency to regulators</strong></td>
<td></td>
</tr>
<tr>
<td>Can the supervisory authority obtain information about ultimate ownership and other corporate governance matters?</td>
<td>Moderately Strong (3)</td>
</tr>
</tbody>
</table>