

Policy Brief on Corporate Governance of Banks in Asia

ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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EXECUTIVE SUMMARY

This Policy Brief identifies corporate governance issues that affect banks and the banking sector in Asia. Banks lend money that is in effect borrowed from depositors, and the failure of banks could result in a monetary loss for the depositors. The interests of depositors should be protected, and for this reason, amongst others, the Task Force believes that the importance of corporate governance of banks differs from that of other companies and needs special attention. The boards and management of banks have to take into account the interests of these non-shareholding stakeholders, i.e. depositors. Reflecting the relatively short history of economic development in the region, many Asian jurisdictions do not have in place sufficient institutional infrastructure (e.g. sufficient resources, experience, focus, and know-how) necessary for effective enforcement of the corporate governance policy framework. Asian banks play a dominant role in regional finance due to the yet immature capital markets, and Asian policy makers should be aware that sound corporate governance of banks cannot be developed effectively without tackling institutional constraints and weaknesses.

The boards of banks should act in line with their fiduciary duties. The fiduciary duties of all board members (i.e. not only of independent directors but all members of the board) include both the duty of care and the duty of loyalty. The fiduciary duties of bank's board members are arguably more important than those of other companies because of the bank's acceptance of public money in the form of deposits. Board members should maintain an attitude of "healthy scepticism" in their assessment of the bank's strategies, policies and processes. Their skills should be enhanced by ongoing training programs that underscore their heightened fiduciary duties. Maintaining and promoting both personal integrity and professionalism of board members of banks is indispensable for the boards to function effectively and properly.

Boards should set the right tone at the top. The board's focus areas should include guiding, approving and overseeing the bank's strategic objectives, corporate values and policies. An important aspect thereof should be the development of a code of conduct for the bank employees, management, and the board members. The board

should clearly define areas of responsibility, authority levels and reporting lines within the bank. Sufficient and material flows of information, internal and external, and managerial support to the board should be ensured.

Competence, integrity and qualifications are a pre-requisite for an effective board.

Board members and executives should pass a “fit and proper person test” in terms of their competence, integrity and qualifications both on the occasion of their appointment and on a continuing basis thereafter. Banking supervisors may play a guiding role therein and in any event are expected to place more emphasis on securing sound corporate governance of banks they supervise rather than to focus only on regulatory compliance.

The board should be able to exercise objective and independent judgement. This is necessary for monitoring managerial performance, preventing conflicts of interest and balancing competing demands. This will mean independence and objectivity with respect to management and controlling shareholders, with important implications for the composition and structure of the board. Although this requirement applies to all companies, in Asia especially banks should be more encouraged than other companies to have independent directors on their boards. One of the main reasons for this is that abusive related party transactions (including lending) may have more serious consequences in banking than in most other industries. “Independent” directors should be independent not only of management but also of controlling shareholders.

Although mandatory separation of the positions of chairman of the board and CEO is not widespread in Asia, the Task Force considers that the separation of these two posts, with due consideration to the business environment in a jurisdiction, can contribute to a more appropriate balance of power, increased accountability and improvement in the board’s capability for decision-making, independent of management.

Bank boards have found it beneficial to establish certain specialised committees.

The audit committee or an equivalent body should, amongst its other duties, ensure that the bank adheres to accounting and auditing standards and practices within the jurisdictions in which the bank operates. Moreover, the bank’s internal auditors should report directly to the audit committee or an equivalent body on matters concerning the effective implementation of policies and controls that are within the competence of the committee. The audit committee is ideally made up of independent directors with appropriate banking and financial expertise. The establishment of a risk management committee should also be encouraged, with the primary duty of overseeing that the bank’s risk management system is properly implementing the risk policy of the bank. The committee structure within the board should preclude decision-making becoming the prerogative solely of any single

individual or of a controlling owner, without a system of independent checks and balances.

Boards should manage related party transactions using independent directors.

Even if related party transactions themselves may be harmless, it is not always easy to judge whether they are on market terms and the mere appearance of conflicts of interest may undermine the ethical code of the bank. Asian experience has shown that special focus should be given to the credit allocation process that banks observe. The specific corporate governance challenge in this regard continues to be that of ensuring that this process is conducted with a view to securing the long-term viability and sustainability of the bank, thereby maximising its long-term value.

Existing regulations covering a bank's lending exposure to a single client, including exposure to related entities owned or controlled by a single client, should be properly implemented and enforced, and where necessary, tightened. A mandatory maximum percentage of lending exposure to a single client of a bank's capital should be set by banking supervisors.

Jurisdictions in Asia should examine whether their current regulatory firewall framework needs to be reinforced

in order to ensure that (i) transactions with controlling shareholders, directors and senior management be conducted on an arm's-length basis, and (ii) proper professional distance is maintained between the credit decisions of banks and the borrowers to which they are related. Related party transactions should be reviewed and monitored by a sufficient number of independent directors capable of exercising independent judgment. In addition, the Task Force stresses the White Paper's recommendation for utilising board committees as a common mechanism for controlling matters involving potential conflicts of interest (White Paper #322).

Related party transactions should be a priority for supervisors. Banking supervisors should implement a strict regulation in which minimum criteria for transactions with related parties that pose special risks are clearly defined. In accordance with international standards for accounting, auditing and non-financial disclosure, banks (including non listed banks if legally possible under the national registration) should publicly disclose material related party transactions.

Moreover, the option of outright prohibition from engaging in *certain specific types of* related party transactions, such as personal loans to board members and controlling shareholders (White Paper #117) should be considered by banks and supervisory authorities.

Banks within groups of companies are commonplace in Asia and need special attention. The corporate governance structure and practices of a bank within a group

of companies should be in accordance with the generally accepted good corporate governance practices. For instance, the board members of the bank, even if they are appointed by the parent company, should be aware that they have specific duties to depositors in addition to the fiduciary duties to all shareholders. Moreover, the bank should adopt firewalls to prevent abusive transactions within the conglomerate structure to which the bank belongs (“banking group”) to the detriment of the bank’s safety and soundness.

The parent company as a single or controlling owner of a bank should appoint a sufficient number of independent directors – independent of both management and the parent company - to the board of the bank and allow the board to fulfil its duties. Furthermore, the parent board itself should also have a sufficient number of independent directors and necessary board committees.

The banking supervisors should also assess the fitness and propriety of the board members and executives of the parent company. Banking supervisors should have the legal authority and tools to effectively supervise the banking group including the parent company.

The legal framework in a jurisdiction should not allow the group structure to obscure where responsibilities lie between a bank and its parent company. Legal obligations of the board of the bank and its parent company should correspond to where decisions are made in the banking group.

Public disclosure is crucial for ensuring sound corporate governance of banks and promoting financial stability. Listed banks should be required by national laws and regulations to be in compliance with international accounting standards and practices as well as the guidance set forth by the Basel Committee in its various publications. Non-listed banks, in so far as they are required to disclose their information to the public, should also adhere to these standards and practices. The Task Force stresses the importance of co-operation between banking supervisors, securities regulators and stock exchanges in terms of public disclosure by listed banks.

State-owned commercial banks should be a role model for good corporate governance. From a corporate governance policy perspective the different roles of the state as (i) a regulator and supervisor, and (ii) an owner of state-owned commercial banks (SOCBs), need to be considered separately. The state should be aware of the potential risks that its intervention, either through prudential regulation or state-ownership, may result in undesirable and potentially harmful consequences. Once the state as sole shareholder has set the objectives for the SOCBs, it should let SOCBs’ boards exercise their responsibilities and respect their independence. The

2005 OECD Guidelines on Corporate Governance of State-Owned Enterprises represent good practices which should also be applied to SOCBs.

Good corporate governance and privatisation are complementary. The Task Force welcomes the general trend towards privatisation of SOCBs in Asia, especially for those banks which were originally taken into state ownership as part of the resolution of a banking crisis. It is imperative for the success of privatisation of a SOCB that the best corporate governance practices are already adopted and implemented prior to privatisation. By doing so, the privatised bank will function as a role model and thus may create market pressure on other banks to adopt better corporate governance.

Asian banks should play an important role in improving the corporate governance structure of their corporate borrowers. The Task Force suggests banking supervisors to develop incentives for banks in Asia to recognise and consider that it is in the best interests of the banks themselves to assess and monitor, *ex-ante* and *ex-post*, the corporate governance structure of its corporate borrowers as a critical part of their ongoing credit risk management.

Banks often allow their employees to act as a member of the board or senior manager of debtor companies even if they do not hold any shares. While bankers with deep knowledge of corporate finance may be able to contribute to these companies, such activities should nevertheless in general be discouraged because of the potential conflicts of interest.

Ensuring sound corporate governance of banks themselves is an essential prerequisite if the banks are to play a more active role in improving the corporate governance of their corporate borrowers.

Asian banking supervisors should take the lead to improve corporate governance of banks in Asia. The Task Force recommends that in all Asian jurisdictions banking supervisors (or banking industry associations, while exchanging views with banking supervisors), in conjunction with securities regulators and stock exchanges (or institute of directors, when appropriate), develop national codes of corporate governance of banks, a template on which banks should base the development of their own codes respectively, based in turn on the conditions of each jurisdiction and on existing corporate governance codes.

Furthermore, banking supervisors should provide incentives for banks to improve their corporate governance. For instance, they should develop rating mechanisms for corporate governance of banks. The methodology of the ratings of corporate governance of banks should be clearly articulated, well in advance in order to provide time for banks to reorganise their framework.

INTRODUCTION

1. The Asian Roundtable on Corporate Governance (“Roundtable”) serves as a regional forum for structured policy dialogue on corporate governance. In 2003, the Roundtable presented the *White Paper on Corporate Governance in Asia* (“White Paper”) which provided region-specific priorities and recommendations for reform to assist policy makers, regulators, stock exchanges, and other standard-setting bodies in Asian economies.
2. At its 2004 meeting in Seoul, the Roundtable decided to establish task forces which are to report back to future Roundtable meetings with policy briefs addressing specific corporate governance challenges shared in Asia and identified in the White Paper. The policy briefs are to focus on policy issues and options and in turn will support efforts in Roundtable economies to improve corporate governance in their jurisdictions. The White Paper identified corporate governance of banks as one of the six priorities for reform and recommended that, “Governments should intensify their efforts to improve the regulation and corporate governance of banks” (White Paper #56). Underpinning this priority for reform is the fact that banks generally play a more important role in the Asian economies than in other economies with more developed capital markets.
3. This policy brief has been developed through active discussions within the Task Force on Corporate Governance of Banks in Asia (“Task Force”). The discussions have been inspired by thought-provoking presentations offered by knowledgeable speakers at a meeting in Tokyo in May 2005, hosted by the Asian Development Bank Institute. While all members of the Task Force occupy senior positions in their respective organisations, the findings and opinions expressed in this policy brief are personal and do not necessarily reflect the views of the organisations they serve or their countries of origin.
4. This policy brief is a non-binding document and has been prepared on a consensus basis. It does not aim at detailed prescriptions for national

legislation or regulation, but seeks to identify objectives and suggest various means of achieving them. Moreover, it does not address, with some exceptions, many of the corporate governance-related issues in banks that overlap with those issues that are also relevant to non-financial companies. Its purpose is to serve as a source of reference together with the *OECD Principles of Corporate Governance* (“OECD Principles”), the White Paper and the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (“SOE Guidelines”). These documents can be used by banks as they work to develop and implement sound corporate governance practices that will in turn result in safer and sounder financial institutions. Supervisors and other policy makers may find these documents of use as they examine and develop the legal and regulatory frameworks for banks.

5. The Task Force does not intend to develop any form of international standards, but is more concerned with effective implementation of existing norms. The Basel Committee on Banking Supervision has revised¹ its guidance on *Enhancing Corporate Governance for Banking Organisations* (“Basel CG Guidance”). Other Basel Committee guidance, such as the *Core Principles for Effective Banking Supervision*, *Internal Audit in Banks and the Supervisor’s Relationship with Auditors* and a number of other risk management and sound practice papers also provide recommendations that enhance corporate governance in banks. The Task Force does not intend to contradict them and its discussions have drawn on them for guidance.
6. There are many bodies that are involved in ensuring sound corporate governance of banks. The primary responsibility for developing and implementing sound corporate governance of banks rests with the individual bank itself. Private bodies such as banking industry associations or institutes of directors often play an important role in assisting boards of directors and senior management of banks in fulfilling their responsibilities. Banking supervisors, on the other hand, have the responsibility to provide a regulatory framework and guidance in terms of corporate governance of banks; they should also monitor individual banks, taking necessary measures when a bank fails to achieve the minimum corporate governance standards necessary for the banking business. In addition, the corporate governance framework (not only of banks but of any corporation) typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country’s specific circumstances, history and tradition. Therefore, this policy brief is addressed to a wide range of participants, including banks, banking industry associations, institutes of directors, stock exchanges, capital market authorities, and banking

supervisors. Some recommendations can be implemented by banks, banking industry associations or banking supervisors while others fall within the jurisdiction of capital market regulators or stock exchanges (e.g. through stock exchange listing requirements) since “banks” referred to in this policy brief can be either listed² or non-listed.

7. Sound corporate governance is evolutionary in nature. To remain competitive in a changing world, banks as well as banking supervisors must continue to innovate and adapt their corporate governance practices and frameworks so that they can meet new demands and grasp new opportunities. Sound corporate governance is also a matter of substance over form. Banks should not stop working to improve their corporate governance merely by fulfilling pro forma requirements. Banks as well as banking supervisors should avoid the pitfall of focusing on the form rather than the spirit when reviewing and assessing banks’ corporate governance practices and the implementation of standards.
8. Some general aspects of the policy brief should be noted at the outset. First, the policy brief does not stipulate any special treatment for small banks; nor does it mean that all banks, from large, internationally competitive banks to small, community banks, should adopt exactly the same measures to improve their corporate governance regardless of their capacity and needs. As the Basel CG Guidance stipulates, corporate governance standards for banks should be appropriate to the size and complexity of the bank, and thus several recommendations in this policy brief may call for a fine tuning of implementation, especially when applied to small banks. Instead of stipulating categorical immunity for small banks in relevant sections of the policy brief, the Task Force considers it would be better to leave the choice to banks or jurisdictions respectively, based on their own size, capacity and national conditions.
9. Second, although the policy brief is oriented towards identifying corporate governance issues that affect banks and banking in general, it also addresses certain issues that are more relevant to specific types of banks, for example, state-owned commercial banks (“SOCBs”) and family-owned banks (“FOBs”), both of which are still predominant in a number of Asian jurisdictions³. In the case of FOBs, a key issue is how to ensure that related party transactions between the bank and its owner family, including group companies controlled by the same family, are conducted on market terms and conditions and in a manner consistent with sound banking practices. With respect to SOCBs, an important issue is how to establish mechanisms that permit the government to act as an active, accountable owner, while at the same time avoiding day-to-day interference with the management of the bank⁴. In addition, in the Asian region there are a number of listed banks which are widely held. For these

banks, the key challenge lies in managing the separation of ownership and control (i.e. the agency problem). Challenges also exist regarding the effective enforcement of regulations and rules by securities regulators and stock exchanges and effective supervision by banking supervisors. Banks with dispersed ownership may be more susceptible to intrusive government intervention in the selection of the CEO and board members, as well as in major operational decisions, than those banks with controlling owners.

10. Third, board structures and procedures vary among Asian economies. Some jurisdictions have two-tier boards that separate the supervisory function and the executive function into different bodies (e.g. in Indonesia, the Board of Commissioners serves a supervisory function and the Board of Directors serves an executive function), while others have unitary boards which bring together these two functions. The policy brief does not advocate any particular board structure; therefore, the term “board” and “directors” as used in this document refers to the supervisory function and not to any particular national model.

Notes

- ¹ February 13, 2006
- ² Use of the term “listed” throughout this paper refers to listing on a stock exchange.
- ³ SOCBs and FOBs referred in this policy brief are not limited to non-listed ones. They include listed ones because the state or family may not always hold all (or a majority) of the bank’s shares, but may instead hold a controlling portion of the voting rights.
- ⁴ The SOE Guidelines also provide guidance on this issue.

PART I.

***THE IMPORTANCE OF CORPORATE
GOVERNANCE OF BANKS AND
CHARACTERISTICS OF ASIAN BANKS***

11. Banks accept money largely in the form of deposits from the general public (i.e. depositors). The nature and size of deposits varies considerably, ranging from large-lot corporate deposits to a number of small deposits in which members of the general public – who do not necessarily have enough knowledge of financial products – entrust their everyday savings. Banks lend money that is in effect “borrowed” from these depositors, and the failure of banks could result in a monetary loss for the depositors with significant consequences for the economy. The interests of **depositors** should be protected, and for this reason, amongst others, the Task Force believes that corporate governance of banks, or the importance of the corporate governance of banks, differs from that of other companies and therefore needs special attention. The boards and management of banks have to pay more attention to the interests of these non-shareholding stakeholders (i.e. depositors) compared to non-financial firms¹. Other reasons why the Task Force believes that corporate governance of banks differs and needs special attention include the following:
- ◆ Shortcomings in corporate governance of banks, if widespread, can destabilise the financial system and pose systemic risks to the real economy (White Paper #57). Banks determine which end-users receive financial resources and provide a means of payment. They also serve as a tool for the execution of monetary policy;
 - ◆ Banks need to be perceived as both accountable to depositors and credible (i.e. they need to protect themselves against reputation risks) in order to manage the potential risk of a run on bank deposits. Banks are not free from the potential risk in which they suddenly become insolvent even if their assets are sound because of their high debt-

equity ratio and the difference in maturity between liabilities (most deposits are available to depositors on demand) and assets (e.g. longer term loans). Moreover, the quality of banks' main assets (loan portfolio) is often rather opaque to outsiders compared with those of non-financial firms;

- ◆ Banks and/or depositors frequently have access to government-sponsored safety nets such as deposit insurance schemes and the provision of liquidity by the central bank. These measures may reduce the incentives for the public (e.g. depositors) to monitor banks. They can change the behaviour of banks towards taking more risk (i.e. moral hazard), and, furthermore, banks can often escape the consequences of improper action for a prolonged period thanks to the safety nets. Poor corporate governance of banks in such circumstances may increase the probability of bank failure leading to high costs for taxpayers; and
- ◆ In addition to the usual institutional constraints that affect all firms, banks are subject to numerous prudential regulations. One can not discuss corporate governance of banks without considering the banking regulations with which banks have to comply. Securing (i) appropriate governance of supervisory institutions (“regulatory governance”), and (ii) efficient regulation, is extremely important to ensure sound corporate governance of banks in general.

12. Discussion about corporate governance of banks in Asia needs to take into account a number of factors specific, if not exclusively unique, to the region. For example:

- ◆ Reflecting the varying legal, economic and cultural backgrounds in Asia, corporate governance practices are similarly diverse (White Paper #33-34);
- ◆ While most Asian jurisdictions have substantially revamped their corporate governance laws, regulations and standards in recent years, challenges arise in their implementation and enforcement². Reflecting the relatively short history of development in the region, many Asian jurisdictions do not sufficiently have in place the institutional infrastructure (e.g. sufficient resources, experience, focus, and know-how) necessary for effective enforcement. Policy makers should be aware that sound corporate governance of banks cannot be developed effectively without tackling the institutional constraints and weaknesses; and
- ◆ Asian banks play a dominant role in regional finance. Capital markets in many Asian economies are not yet as mature as in many market-oriented countries. The failure of corporate governance of

banks in Asia has resulted in more serious economic consequences than in other regions (e.g. 1997 Asian crisis).

Notes

- ¹ It is true that non-financial firms also have creditors (and even banks have creditors other than depositors), but the interests of depositors should be treated with specific careful attention by the boards and management compared to other creditors, because the depositors entrust their money in the form of *deposits* that can be withdrawn at short notice and they represent a major component of the balance sheet.
- ² In this respect reference is made to the 2006 Stock-take Report by the Asian Roundtable on Corporate Governance (forthcoming).

PART II.

MAIN ISSUES AND PRIORITIES FOR REFORM IN CORPORATE GOVERNANCE OF BANKS IN ASIA¹

2.1 The responsibilities of individual board members in Asian banks

13. The fiduciary duties of all board members (i.e. not only of independent directors but all members of the board) include both the duty of care and the duty of loyalty. The fiduciary duties² of banks' board members are arguably more important than those of other companies – irrespective of the legal traditions of the jurisdiction where the banks are operating – because of the banks' acceptance of public money in the form of deposits to fund their operations. In addition to the fiduciary duties that apply to board members of all companies, board members of banks need to be conscious, and regularly reminded by banking supervisors, of their fiduciary duties to depositors because banks accept and manage other people's money in the form of deposits. Last but not least, board members and executives of banks should have high ethical standards.
14. It follows that these duties of board members of banks cannot be fully, properly and effectively discharged without sufficient skills and personal abilities, including maintaining an attitude of "healthy scepticism" in their assessment of management and the bank's strategies, policies and processes. Their skills should be enhanced by ongoing training programs (provided by, for example, stock exchanges or professional associations such as banking industry associations and institutes of directors) that underscore the professional, ethical and technical demands that the heightened fiduciary duties impose upon a bank's board members. Maintaining and promoting both personal integrity and professionalism of

the board members of banks is indispensable for the banks' boards to function effectively and properly.

2.2 The roles and functions of the board in Asian banks

15. The board is not only accountable to shareholders and depositors but also has a duty to act in their best interests. Together with guiding a bank's strategy, the board is responsible for supervising managerial performance and achieving an adequate return for shareholders, while avoiding conflicts of interest³ and balancing the competing demands on the bank (e.g. demands from depositors, shareholders, borrowers, creditors, employees, etc.). This policy brief does not repeat every specific function of the board as they are more fully developed in the OECD Principles and the Basel CG Guidance. Rather, attention is given to issues that the Task Force considers to be of particular importance to the boards of banks.
16. Banking and banking transactions are becoming increasingly complex, often involving counterparts in other jurisdictions, and are subject to rules and regulations that are becoming more specific and technical. In spite of these developments, or probably because of them, the boards of banks are required to be more involved in the broad strategy rather than becoming immersed in day-to-day management of the banks. More specifically, the board of a bank should focus on (i) guiding, approving and overseeing the bank's strategic objectives, corporate values and policies, and (ii) the creation of structures and processes which include setting up both clear lines of responsibility and accountability throughout the bank, and strict internal control systems ensuring effective oversight⁴.
 - (i) An important aspect in the guidance and approval of policies by the board is the development of a code of conduct (or code of proper practice)⁵ for the bank employees, management, and the members of the board. It is incumbent on board members to ensure high ethical standards throughout the bank so that the management will be more effective and transparent in balancing the often conflicting demands from employees, borrowers, and other stakeholders. In doing so, the board is responsible for setting the "tone at the top" to promote a bank culture with high ethical standards. For example, board members should abstain from voting or even taking part in any decision-making processes on any matter that may involve them in a potential conflict of interest. They should not interfere in those decisions and avoid creating even the appearance of self-dealing;
 - (ii) The board should clearly define areas of responsibility, authority levels and reporting lines within the bank. For instance, the board should evaluate the performance of, and have the power to appoint and remove

key executives, including the CEO; it should ensure that senior management establishes a process of well-defined decision-making authority for the staff, including workable internal control systems; it should make it clear that executives are ultimately responsible to the board for the performance of the bank; and finally, dedicated, specialised executives⁶ should be designated as directly accountable to the board in terms of specific key functions.

17. If the board is to fulfil its functions properly, sufficient flows of information, internal and external, and managerial support to the board should be ensured. This will enable effective and timely decision-making and oversight by the board. Senior management should recognise the critical function of the board under a modern corporate governance regime and the necessity to provide sufficient information, analysis and support to the board⁷. While board members, especially non-executive directors, should not be involved in day-to-day management of the bank, they should nevertheless have access to the staff, its technical expertise and any information they may require to properly fulfil their duties. Furthermore, the board should have the financial resources to obtain additional advice and analysis from outside experts when appropriate. Last but not least, the board should have sufficient opportunities to obtain views directly from internal and external auditors⁸.
18. Board members and executives should pass a “fit and proper person test”⁹ in terms of their competence, integrity and qualifications both on the occasion of their appointment and on a continuing basis thereafter. Moreover, the performance of the board as a whole and that of individual board members should be regularly evaluated by the board. For this purpose, the board should establish its own internal committee, ideally made up of independent directors, to undertake such a performance evaluation in a fair and constructive manner (see paragraph 26 hereinafter).
19. Banking supervisors are expected to place more emphasis on securing sound corporate governance of banks they supervise rather than to focus only on regulatory compliance. As the role of the board is crucial in developing sound corporate governance of banks, banking supervisors should assess the performance of the entire board by, for instance, reviewing minutes of board meetings, and by checking the availability to board members of necessary information and resources, including staff support. In addition, with due consideration to national conditions, they may also be legally entitled to observe board meetings of banks when they think it is appropriate. They should issue warnings and, when necessary, ask the bank to reorganise its board framework and operational procedures

in order to secure sound corporate governance, not only in form but also in substance.

2.3. The composition of the board

20. In exercising its duties of monitoring managerial performance, preventing abusive conflicts of interest and balancing competing demands, the board should be able to exercise objective judgement. This will mean independence and objectivity with respect to management and controlling shareholders, with important implications for the composition and structure of the board. Although this requirement applies to all companies, in Asia especially banks should be more encouraged than other companies to have independent directors on their boards. One of the main reasons for this is that abusive related party transactions (including lending) may have more serious consequences in banking than in most other industries. The incentives to enter into related party transactions, especially in the case of FOBs, may also be much greater than in most other companies. The OECD Principles stipulate that the review of related party transactions should be undertaken by a sufficient number of non-executive board members capable of exercising “independent” judgement to ensure that such transactions are conducted at arm’s length and in the interest of the bank (OECD Principles, principle VI. E. 1.).
21. Controlling shareholders in Asia, typically in the case of FOBs, often appoint the entire board; thus, the real objectivity and independence, and resulting value of nominally “independent” directors can be undermined. “Independent” directors should be independent not only of management but also of controlling shareholders¹⁰. This issue is also relevant to SOCBs. The boards of SOCBs should include a sufficient number of “independent” directors so that the board is able to make decisions independent of the state’s possible (politically driven) day-to-day intervention, while effectively monitoring the management in accordance with the objectives set by the state in its capacity as an owner or a controlling shareholder¹¹. The Task Force strongly advocates the White Paper’s recommendation that “Asian countries should continue to refine the norms and practices of ‘independent’ directors” (White Paper #318).
22. Although mandatory separation of the positions of chairman of the board and CEO is not widespread in Asia, the Task Force considers that the separation of these two posts, with due consideration to the business environment in a jurisdiction, can contribute to a more appropriate balance of power, increased accountability and improvement in the board’s capability for decision-making, independent of management. In that case, the chairman should ideally not only be a *non-executive* but also an

independent director so that the board which he/she chairs can make more objective, independent decisions. However, in countries where it is difficult to attract *independent* directors in general, the appointment of a *non-executive* chairman, for the time being, would contribute towards achieving a better balance of power on the board and improve the operation of checks and balances. In the case of two-tier board systems, the chair of the two boards should be separated. Also, the tradition in which the head of the managing board becomes the chairman of the supervisory board on retirement should be set aside¹². A relevant committee should nominate a qualified person as the chair of the board in accordance with objective criteria.

2.4. The committees of the board

23. The Basel CG Guidance notes that in a number of countries, bank boards have found it beneficial to establish certain specialised committees; examples include an audit committee¹³, a risk management committee, a compensation committee and a nomination committee. In Asia, banks are increasingly mandated by law to establish such dedicated committees within boards.
24. As the Basel CG Guidance stipulates, the audit committee is typically responsible for (i) providing oversight of the bank's internal and external auditors; (ii) approving (or recommending to the board of directors or shareholders for their approval) the appointment, compensation and dismissal of external auditors; (iii) reviewing and approving audit scope and frequency; (iv) receiving audit reports; and (v) ensuring that management is taking appropriate corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors (Basel CG Guidance #22). The audit committee or an equivalent body should, amongst its other duties, ensure that the bank adheres to accounting and auditing standards and practices within the jurisdictions in which the bank operates¹⁴. Moreover, the bank's internal auditors should report directly to the audit committee or an equivalent body on matters concerning the effective implementation of policies and controls that are within the competence of the committee. The audit committee is ideally made up of independent directors¹⁵ with appropriate banking or financial expertise.
25. The establishment of a risk management committee should also be encouraged, with the primary duty of overseeing that the bank's risk management system is properly implementing the risk policy of the bank. Relevant risks include credit, market, liquidity, operational, compliance, reputational and other risks of the bank. Its role should include reviewing

the risk management policies of the board and also requesting and obtaining from senior management periodic information on both risk exposures and risk management activities. It should ensure that an adequate process of risk management is developed and that controls are properly enforced.

26. To avoid the proliferation of too many board committees, an alternative may be to establish a single committee that combines the responsibilities for nomination, remuneration, succession planning and other board members' concerns including their ongoing training and access to technical support and information¹⁶. Such a committee – which could be called a “governance committee” – should also regularly evaluate the performance of board members and the board as a whole in a fair and constructive manner based on clearly-written criteria. It is essential that the governance committee, which ideally is made up of independent directors, operates to secure the independence and enhance the capacity for independent judgment of board members and the board as a whole. In this regard, the nomination of independent directors which, in practice, is often made by the controlling shareholders, should be transferred to the nomination or governance committee.
27. Finally, as discussed in further detail in paragraph 31 below, it is also worth considering the establishment of a specialised committee for monitoring and approving related party transactions which in particular in the Asian context remain a serious problem.

2.5. Appropriate credit allocation: preventing abusive related party transactions

28. There are many forms of related party transactions, and not all of them are harmful (e.g. they can be made on market terms) but they do often involve (potential) conflicts of interest. Banks should be careful about making decisions concerning these transactions because it is not always easy to judge whether they are on market terms (i.e. on an arm's-length basis). Moreover, even if related party transactions themselves are harmless, the mere appearance of conflicts of interest may undermine the ethical code of the bank. In Asia, experience has shown that special focus should be given to the credit allocation¹⁷ process that banks observe. The specific corporate governance challenge in this regard continues to be that of ensuring that this process is conducted with a view to securing the long-term viability and sustainability of the bank, thereby maximising its long-term value. The committee structure within the board should preclude decision-making becoming the prerogative solely of any single individual or of a controlling owner, without a system of independent checks and

balances. An appropriate credit allocation process can be secured by mechanisms as discussed hereinafter (i.e. firewalls) to prevent self-dealing and the favourable treatment of related parties.

29. Existing regulations covering a bank's lending exposure to a single client, including exposure to related entities owned or controlled by a single client (single borrower's limit), should be properly implemented and enforced, and where necessary, tightened. A mandatory maximum percentage of lending exposure to a single client of a bank's capital (generally accepted international practice prescribes it as a ceiling of 25%) should be set by banking supervisors¹⁸.
30. In recognition of the damage inflicted on entire economies from abuse of related party lending, some jurisdictions have started to go further, even to the extent of limiting ownership and voting rights of individual owners or of a single family in a bank for certain types of votes¹⁹. Other jurisdictions are moving towards setting up strong firewalls between the controlling ownership of financial and non-financial companies. The above mentioned regulations are simply examples, and it should be noted that this policy brief does not necessarily intend to recommend that other jurisdictions adopt exactly the same regulations, as jurisdictions should carefully consider both the benefits and costs of such possible regulations based on their national conditions. In any case, jurisdictions in Asia should examine whether their current regulatory firewall framework needs to be reinforced in one way or another in order to ensure that transactions with controlling shareholders, directors and senior management are conducted on an arm's-length basis and that proper professional distance is maintained between the credit decisions of banks and the borrowers to which they are related.
31. Related party transactions should be reviewed and monitored by a sufficient number of independent directors capable of exercising independent judgment. In addition, the Task Force stresses the White Paper's recommendation for utilising board committees as a common mechanism for controlling matters involving potential conflicts of interest (White Paper #322). In this respect, one of the options to be considered may be establishing a committee of the board responsible for reviewing related party transactions, whose membership is ideally made up exclusively of independent directors.
32. The Basel Committee's *Core Principles for Effective Banking Supervision*²⁰ recommend that banks report to national banking supervisors any *transactions with related parties that pose special risks to the bank*. Therefore, banking supervisors should implement a strict regulation in which minimum criteria of such "transactions with related

parties that pose special risks” are clearly defined. In so doing, the regulatory framework should make it clear that such minimum criteria merely stipulate examples of transactions and are not exhaustive. Thus, the bank’s board is still required to monitor and report those transactions that are not on the list but may nevertheless pose significant risks for the bank. In the reports regarding such transactions, the board of the bank should be required to provide an assessment of the nature and amount of risks posed, as well as the measures taken to manage conflicts of interest and therefore mitigate such risks.

33. In accordance with international standards for accounting, auditing and non-financial disclosure, banks should disclose material related party transactions. For non-listed banks, while they should be required to report the nature and extent of these transactions to the banking supervisor, public disclosure by these non-listed banks to other stakeholders (e.g. depositors) would, if legally possible under the national legislation, facilitate even more effective monitoring of their corporate governance practice. It is important for the market and stakeholders, in addition to the banking supervisors, to know whether the bank is being run with due regard to the interests of all its stakeholders, and therefore it is essential for the bank to fully disclose material related party transactions either individually or on an aggregate basis. It will also help banking supervision and reduce the logistical burden for banking supervisors who may have limited human resources.
34. Finally, the White Paper’s recommendation implies that there is also an option of prohibiting listed companies from engaging in *certain specific types of* related party transactions, such as personal loans to board members and controlling shareholders (White Paper #117). Banks and supervisory authorities should consider this option of outright prohibition for certain specific types of related party transactions.

2.6. Bank holding companies and groups of companies including banks

35. Depending on the legal framework of the jurisdiction in which they operate, banks can be a subsidiary or parent company or both. Although conglomerate structures to which banks belong (hereinafter “banking group”) vary widely²¹, all of them need special consideration in respect of their corporate governance. The corporate governance structure and practices of both the bank itself and the banking group are a legitimate concern of public policy because banks are entrusted with deposits that are often protected by public safety nets. Major challenges for banking groups may lie in preventing abusive related party transactions to the detriment of

depositors of a bank within such groups, and avoiding ambiguity in terms of the division of labour and corresponding responsibilities between the bank and its affiliated parent company or subsidiaries.

36. The legal form and the position of a bank within a banking group does not lessen the responsibility of the bank's board members and senior management to operate the bank in accordance with sound corporate governance practices²². The corporate governance structure and practices of the bank within a banking group should be in accordance with the recommendations stipulated in other parts of this policy brief (i.e. banks should be subject to strict corporate governance standards irrespective of whether or not they belong to a banking group). For instance, the board members of the bank, even if they are appointed by the parent company, should be aware that they have specific duties to depositors in addition to the fiduciary duties to all shareholders. The bank's board should include a sufficient number of independent directors who are also independent from the parent company. A member of the board of the bank should not be regarded as an "independent" director if he/she is materially connected to the parent company. In addition thereto, the Task Force considers that an independent director of the parent board who also serves on the board of a bank is not considered to be an "independent" director of the bank board, with the rare exception where the parent company is a "pure" holding company which holds the entire equity of the bank and does not engage in other businesses than holding the equity of that bank. Appropriate committees whose members include independent directors (exclusively, if possible) should be established, with some exceptions, even if the bank is wholly owned by a parent company because, in many cases, there is a need for objective judgment by independent directors who may more readily represent the interests of depositors than non-independent directors. Moreover, the bank should adopt firewalls mentioned in section 2.5 in order to prevent abusive transactions to the detriment of the bank's safety and soundness.
37. A bank's parent company should not impede the full exercise of the corporate governance of the bank within a banking group, although some activities such as internal audit and risk management might need to be considered by the banking group as a whole. The parent company should refrain from intervening in day-to-day operations of the bank, especially with regard to specific decisions on lending and investments. As mentioned above, the parent company as a single or controlling owner should appoint a sufficient number of independent directors – directors not only independent of management but also of parent companies – to the board of the bank, and allow the board to fulfil its duties. Furthermore, the parent board itself should also have a sufficient number of independent

directors and the necessary board committees as discussed in section 2.4. The banking supervisors should also assess the fitness and propriety of the board members and executives of the parent company.

38. Banking supervisors should have the legal authority and tools to effectively supervise the banking group including the parent company. The extent to which they should supervise the banking group may depend on the level of control. In the case of a “pure” holding company, for instance, the banking supervisors should have virtually the same legal authority over the holding company as over the bank, including the authorisation and revocation of licenses and the undertaking of supervisory enforcement actions, when appropriate. They must have the means and legal powers to gather information, both on and off-site, not only from banks but also from their parent companies. The legal framework in a jurisdiction should not allow the group structure to obscure where responsibilities lie between a bank and its parent company. The legal obligations of the board of the bank and its parent company should correspond to where decisions are made in the banking group.

2.7. Disclosure

39. The White Paper also recommends that Asian countries should work towards full convergence with international standards and practices for accounting, audit and non-financial disclosure²³ (White Paper #202). Public disclosure is crucial for ensuring sound corporate governance of banks and promoting financial stability in a country. Listed banks should be required by national laws, regulations and rules to be in compliance with international accounting standards and practices as well as the guidance set forth by the Basel Committee in its various publications, including the *Enhancing Transparency in Banking*. In terms of non-listed banks, banking laws in Asian jurisdictions often mandate certain disclosure requirements to the public even if they are non-listed because the general public entrusts their savings to banks. In that case, non-listed banks, in so far as they are required to disclose their information to the public, should also adhere to these standards and practices. In the case of SOCBs, they should, whether listed or not, be subject to an annual independent external audit based on international standards adopted by national laws, regulations and rules (in addition to the specific state audit which is mainly designed to monitor public funds and the use of budget resources). The state should maintain a continuing dialogue with the external auditors of the SOCBs so long as this is compatible with company law.

40. Concerning compliance with disclosure requirements by listed banks, the Task Force would like to stress the importance of co-operation between banking supervisors, securities regulators and stock exchanges. Even if the primary authority for ensuring proper disclosure of banks rests with banking supervisors, securities regulators are not exempt from their responsibilities; as noted in the White Paper, securities regulators are required to exercise oversight and enforcement of standards for accounting, audit, and non-financial disclosure (White Paper #238). Problems regarding disclosure by listed banks identified either by banking supervisors or securities authorities including stock exchanges should be shared by both organisations in due course for possible corrective actions and sanctions according to relevant laws and regulations.

2.8. Banks' autonomy in relation to the state

41. Because of the banking system's important role in the economy of most Asian jurisdictions, the state usually has a clear interest in banks' operations. Besides financial safety nets, the state's interest can be manifested through prudential regulation and/or the state ownership of bank shares. The role of the state as (i) a regulator and supervisor, as well as (ii) an owner should be considered separately, in accordance with the SOE Guidelines (Chapter I). Furthermore, the state should be aware of the potential risks that its intervention, either through prudential regulation or state-ownership, may result in undesirable and potentially harmful consequences (See also OECD Principles, Chapter 1).
42. In terms of prudential regulation, there has been a steady and justifiable trend in which banking supervision has been required to be strictly and effectively enforced. It should be noted that excessive regulation and exercise of supervisory authority, often driven by political consideration, can be counter-productive. Moreover, virtually any prudential regulation may, more or less, potentially distort the incentive structure for management (e.g. regulations relating to bank ownership, which are necessary and recommended, may nevertheless lead to potential moral hazard through management's entrenchment if the market in corporate control is restricted.). Policy makers should take into account national conditions and carefully consider both benefits and costs, including possible distortions, when they are considering new regulation.
43. In the case of SOCBs, policy goals set by the state cannot be achieved efficiently by the intervention of government in day-to-day management of SOCBs. It would even be harmful if such intervention is not disclosed and, consequently, neither the state officials nor the board and senior management of SOCBs is accountable for the results of the intervention.

For instance, state officials should not interfere in any specific lending decision of SOCBs even if the SOCBs are specifically dedicated to implementing certain state-designed lending policies (e.g. agricultural finance). Instead, the state should properly utilise and respect the legal corporate structure of SOCBs, which is most often that of a joint stock company. That is, once the state as sole shareholder has set the objectives for the SOCBs, it should let SOCBs' boards exercise their responsibilities and respect their independence. Thus the authorities should take advantage of the corporate form which is presumably one reason for separating the banks from the administration in the first place. The SOE Guidelines represent good practices which should also be applied to SOCBs.

44. The Task Force welcomes the general trend towards privatisation of SOCBs in Asia, especially for those banks which were originally taken into state ownership as part of the resolution of a banking crisis. Generally speaking, the privatisation of state-owned banks (with limited exceptions such as policy lending banks, e.g. development banks), can bring market discipline and thus improve corporate governance. It is imperative for the success of the privatisation of a SOCB²⁴ that the best corporate governance practices available in a jurisdiction are already adopted and implemented prior to privatisation. By doing so, the (re-)privatised bank will function as a role model of sound corporate governance and thus may create market pressure on other banks to adopt better corporate governance. It will also place new shareholders in a difficult position if they wish to reverse such reforms.

2.9. Banks' monitoring of the corporate governance structure of their corporate borrowers

45. Regardless of the efforts to develop sound capital markets, banks in many Asian jurisdictions still play a more or less dominant financial role and often wield power over borrowing companies. This explains why, in the course of discussions at the Roundtable meeting that established the Task Force, participants pointed out the necessity of a supplemental discussion on the role of banks in the corporate governance structure of their corporate borrowers. The discussion about this topic seems to have two aspects: (i) whether banks should actively assess and monitor the corporate governance structure of their borrowing companies, and (ii) to what extent banks should seek to improve the corporate governance of borrowing companies.
46. In terms of (i) above, the Task Force suggests that banks in Asia should recognise and consider that it is in the best interests of the banks

themselves to assess and monitor, *ex-ante* and *ex-post*, the corporate governance structure of its corporate borrowers. Such an evaluation of a borrower's character is a normal part of the credit granting and review process. Since poorer corporate governance practices on the part of borrowers have a direct impact on their overall creditworthiness, both (i) the assessment of the corporate governance structure of companies to which banks are considering to provide loans, and (ii) the monitoring of these structures until the loans are repaid, form an important part of proper risk management. Research shows that this practice has been largely neglected in many Asian banks. Banking supervisors in Asia should therefore encourage banks to assess and monitor²⁵ the quality of the corporate governance structure of their debtor companies as a critical part of their ongoing credit risk management. Considering that securing sound corporate governance through securities market pressure, which in many cases is some way off due to the lack of well-functioning securities markets, the assessment and monitoring function of banks as a part of risk management may deserve more attention not only from banks, but also from policy makers and banking supervisors, as one of the effective policy tools for improving corporate governance practices in a country.

47. In terms of (ii) in paragraph 45, the extent to which banks should try to influence the practices of their corporate borrowers needs careful consideration:
- (i) For instance, banks often allow their employees to act as a member of the board or senior manager of debtor companies even if they do not hold any shares. While bankers with deep knowledge of corporate finance may be able to contribute to these companies, such activities should nevertheless in general be discouraged because of the potential conflicts of interest. Furthermore, such a board member should not be regarded as an "independent director"; and
 - (ii) One cannot expect banks with poor corporate governance to monitor and seek better corporate governance of their corporate borrowers. Banks whose minority shareholders are exploited by a controlling shareholder, for instance, might permit the borrowing companies to do the same or even allow those companies controlled by the same controlling shareholder to exploit the banks themselves. Ensuring sound corporate governance of banks themselves is an essential prerequisite if the banks are to play a more active role in improving the corporate governance of their corporate borrowers.

2.10. Next steps

48. The Task Force includes both banking supervisors and securities authorities who have each been separately discussing the corporate governance challenges of banks. It is indeed an inter-disciplinary issue across the areas of banking supervision and securities regulation as far as listed banks are involved. Acknowledging the unique features of corporate governance of banks and the necessity of harmonisation with existing rules applicable to non-financial listed companies, the Task Force recommends that banking supervisors (or banking industry associations, while exchanging views with banking supervisors) in Asia, in conjunction with securities regulators and stock exchanges (or institute of directors, when appropriate), should develop (making use of public consultation with market participants) and publicise a code of corporate governance of banks, a template on which banks should base the development of their own codes respectively, based in turn on the conditions of each jurisdiction and on existing corporate governance codes.
49. Furthermore, banking supervisors should provide incentives for banks to improve their corporate governance. For instance, taking into consideration the suggested code mentioned above, they should develop rating mechanisms for the corporate governance of banks. Such a rating can be designed either as a rating specifically focused on corporate governance, or as a part of a broader rating mechanism within which factors regarding corporate governance play one of the major roles in determining overall ratings. Another example of incentives is the possible differentiated deposit insurance premium reflecting ratings mentioned above, instead of the existing flat-rate system. If the costs of deposit insurances or deposit guarantee schemes that banks must share reflect their ratings related to corporate governance, it will provide incentives for the banks to improve their corporate governance. The methodology of the ratings of corporate governance of banks should be articulated as clearly as possible and should be announced well in advance in order to provide time for banks to reorganise their framework. It will also be necessary to emphasise principles and to avoid box-ticking actions by banks. Securities authorities should contribute to developing the criteria by providing their accumulated knowledge and experience about corporate governance.

Notes

- ¹ The order of issues and challenges discussed in this policy brief follows logically and thus does not imply anything about the relative importance of the issues discussed.
- ² While the heightened fiduciary duties of individual board members of a bank, or the board as a whole, are mentioned further in other parts of this policy brief, one member of the Task Force suggests that it would, more specifically, include; (a) the duty to act in good faith in the best interests of banks including depositors, (b) the duty to act for a proper purpose, (c) the duty to control conflicts of interest, (d) the duty to properly disclose banks' information, and (e) the duty to properly act *vis-à-vis* breaches found within banks. In addition, as this member also stresses, the high ethical standards that should be applied to the individual board members and the board of banks cannot be overemphasised.
- ³ Or properly managing conflicts of interests where they cannot be fully prevented.
- ⁴ Although these recommendations are not exclusively true to banks but to any firms, both financial and non-financial, they are worth emphasising here as they are critical.
- ⁵ The code of conduct should emphasise principles and avoid promoting box-ticking behaviour.
- ⁶ These include any executives who hold the title of, for instance, chief credit officer, chief financial officer, chief compliance officer, chief lending officer, chief investment officer, or, without regard to title, any person who performs the function of one or more of these positions.
- ⁷ As mentioned in paragraph 14, continued training for the members of the board is important in order for them to effectively analyse the information they obtain.
- ⁸ For the responsibilities of internal and external auditors, see the Basel Committee's guidance; *Internal Audit in Banks and the Supervisor's Relationship with Auditors*.
- ⁹ The test should be designed in accordance with the Basel Committee's guidance such as the *Core Principles for Effective Banking Supervision* and the *Core Principles Methodology*.
- ¹⁰ One code suggests that relationships and circumstances which could lead to board members not being "independent" include, but not be limited to, the cases in which (i) board members have, or have had within the last

three years, a material business relationship with the company (bank) either directly, or as a partner, shareholder or director or senior employee of a body that has had such a relationship with the company (bank), or (ii) board members represent a significant shareholder.

¹¹ In this respect, reference is made to the annotation to guideline II. C. of the SOE Guidelines.

¹² If it is impractical to immediately put an end to such tradition, it would be desirable to request, at least for the time being, an appropriate transition period of some years where the former lead management, after their retirement, be prohibited to chair the board. The Task Force recommends this because any changes proposed by a new CEO should not be assessed by his/her predecessor, who may not be inclined to be objective or accept changes from how he/she managed the bank.

¹³ The Basel CG Guidance stipulates that “the Committee believes that it is appropriate and beneficial for large, internationally active banks to have an audit committee or equivalent structures responsible for similar functions.” (Basel CG Guidance #22)

¹⁴ Jurisdictions in Asia “should work towards full convergence with international standards and practices for accounting, audit and non-financial disclosure.” (White Paper #202. See also OECD Principles V.B). Any guidance of the Basel Committee related to disclosure including *Enhancing Transparency in Banking* should also be respected.

¹⁵ As discussed in paragraph 21, *non-executive* directors are not always *independent* directors.

¹⁶ It should be noted that the establishment of such an integrated committee with multiple functions is merely a suggestion as a policy option reflecting national conditions. If a jurisdiction follows this suggestion, relevant laws/regulations/codes may, instead of uniformly requiring all banks to establish such committees, leave the choice to banks, reflecting their conditions, size and capacity.

¹⁷ Credit allocation is not limited to providing loans. It also includes debt guarantee, investment and any form of financial transaction, so that the related party transactions are not limited to loans.

¹⁸ In addition to such a ceiling, one Asian jurisdiction legally restricts the amount of lending to controlling shareholders to within the amount of their capital contribution to the bank.

¹⁹ In view of the fact that control of banks is often associated with shares having voting rights considerably in excess of cash flow rights, mandatory voting caps in banks for electing independent directors who will serve on certain committees are recommended.

- ²⁰ The *Core Principles for Effective Banking Supervision*, together with the *Core Principles Methodology*, are under review as of June 2006.
- ²¹ A parent company which has a banking subsidiary could be a “pure” bank holding company which owns 100% of the bank’s shares and does not engage in other businesses. It could be a financial holding company which holds the shares of banks and other financial institutions. It could also be a company engaging in its own commercial operations while holding the controlling shares of the bank. On the other hand, subsidiaries of banks could include other banks, financial institutions and/or other commercial companies if the law so permits.
- ²² As a matter of fact, the board of the bank within a banking group is expected to take a wider range of facts into consideration than those of other banks, especially when the bank is a parent company. It should pay attention to the operations of other companies within the banking group because problems or scandals in such companies may result in reputation risks to the bank. Above all, the banking group should be a source of strength and not weakness for the bank.
- ²³ It should be noted that, as mentioned in the White Paper #205, local conditions from country to country may require adoption of international standards individually (rather than all at once) and/or at different speeds.
- ²⁴ Needless to say, the process of privatisation should be fair and transparent.
- ²⁵ The monitoring function of banks *may* be supplemented by or substituted with covenants between banks and their corporate borrowers. Such a covenant should stipulate conditions regarding the corporate governance structure of the borrowers, and a deviation from this may lead to the bank’s withdrawal of credit. It is desirable that these conditions are drafted in a way that a violation thereof can be easily judged (e.g. maintaining a minimum ratio of non-executive directors or separation of a chairman and a CEO) in order to prevent excessive intervention by banks, improve potential enforcement, and avoid unnecessary dispute. The covenant should involve the obligation of corporate borrowers to report to the bank when a deviation from it occurs, which would reduce the burden of monitoring by the bank.

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