Corporate Governance of Banks in Eurasia

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The Outline of the Policy Brief

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Outline of the Policy Brief

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The Task Force on CG of Banks in Eurasia

- The OECD and the World Bank Group promote five regional roundtables on corporate governance (CG) around the world.
  - **Eurasian Roundtable** (Roundtable) was established in 2000.

- The Roundtable identified six priorities of reform

  "*Governments should intensify their efforts to improve the regulation and* ***corporate governance of banks****.*"

- The Roundtable launched a **task force** on bank governance
  - Experts in banking or capital market
  - Experts from Eurasia, OECD countries and international organisations
  - To develop a policy recommendations/options paper (Policy Brief)
  - OECD and EBRD serves as secretariat

What is the Policy Brief

- Nature of the Policy Brief
  - **Non-binding.** Serves as **a source of reference.**
    - No detailed prescriptions for national laws/regulations
    - May call for a fine tuning for small banks
    - Not an exhaustive textbook
    - → *OECD Principles, SOE Guidelines, etc*
- Harmonisation with the **Basel Committee's work**

  Enhancing Corporate Governance for Banking Organisations
- Developed in the **Eurasian context**
- Would assist wide range of people;
  - Policy makers, banking supervisors, banking associations, capital market regulators, stock exchanges and, last but not least, banks

Why is bank governance so important?

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

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

- Boards are crucially important

- **Independent directors** (IDs), not just non-executive directors (see Annex)

(A) Independence from **senior management**

For instance

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

(B) Independence from **controlling shareholders**

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

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

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

- Board member's qualification
  - **Collective** knowledge as an entire board. Some members should have a sufficient knowledge of banking on appointment
  - Trainings including CG awareness-raising program

- Boards' specialised committees
  - Board **audit committee** is recommended. "*Revision Commission*" cannot substitute for board audit committees
  - Other committees are also important
    - **Nomination committee, risk management committee**
  - Rather than formalities, what matters more is that bank has effective, **well-functioning** committees

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

- Strategic objectives & other guiding policy documents
  - In approving/reviewing them, the supervisory board should be able to receive necessary **support from the management board**

- Compliance oriented bank culture
  - **The board** is responsible for nurturing sound bank cultures
    - By awareness-raising programs, incentive schemes, analysing failures, becoming a role model, and developing code of conduct
  - Banks should make public their compliance structure and activities
  - Employees should be **encouraged** to communicate their concerns
    - **Procedures** (including confidential direct access) should be specified
    - **Protection** should be secured

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

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

Chapter 3. Clear lines of responsibilities and accountability

Clear, **not multiple** lines

- The board (supervisory board) should occupy superior position over senior management (the management board)

- The supervisory board should have power in relation to **appointment & removal** of the management board
  - The supervisory board should be encouraged to nominate candidates for the management board

Chapter 4 Oversight by senior management and internal control functions

- Internal control
  - Started with reducing fraud, misappropriation and errors
  - Becomes more extensive, **addressing all risks**

    Credit risks, market risk, interest rate risk, liquidity risk, operational risk, etc.

- Who should do, and what to do?
  - In varying degrees, **everyone**'s responsibility in banks
  - **Senior management** should establish, monitor and improve it
  - **Boards** should ensure that senior management does so

- **"Four Eyes Principle"** as an integral part of daily operations

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

- Internal audit should have **appropriate status to have senior management react** on its findings.

- Are "Revision Commissions" working effectively?
  - ✓ Statutory bodies other than the boards
  - ✓ Responsibilities in relation to internal audit and supervision
  - ✓ Appointed at general shareholder meetings, not by the boards
  - ✓ Mostly report directly to general shareholder meetings

→ "Revision Commissions" cannot substitute for board audit committees. It is suggested to make it **optional** for banks to **replace** them by creating **board audit committees**.

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

- External auditors
  - **Rotation** of audit engagement team (if not the audit firm).
  - Limitation on non-audit work
  - Effective sanctions to **dissuade** unprofessional behaviour

- External auditors and banking supervisors
  - They have **complementary** concerns. But the focus of their concerns is **different**. The normal relationship between auditors and their clients should be **safeguarded**.
    - legal basis for banking supervisors to **hear the views** of auditors
    - Legal obligation to report material **breach** of laws to banking supervisors
    - Legal protection or **immunity** when they report
    - Banking supervisors should reject and rescind inappropriate auditors

Chapter 6. Compensation

- Extraordinary **low** remuneration for bank boards (supervisory boards) is not desirable
  - Extraordinary low remuneration may be signalling the board's ineffectiveness

- Banking supervisors or banking associations may want to provide **guidance** on compensation
  - Based on the guidance, banks are encouraged to develop their own remuneration policy

Chapter 7. Transparency and disclosure in terms of CG

- Ensuring appropriate public disclosure is important
  - Market discipline
  - Harmonisation to **internationally recognised standards** on accounting (e.g. IFRS) and auditing (e.g. ISA)

- Among governance-related disclosure items, information on **ownership structure** is crucial.
  - Not only record ownership but also **beneficial ownership** (i.e. real owner)

- **Co-operation** between banking & capital market supervisors
  - Information sharing and harmonisation of disclosure requirements

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

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

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

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

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

- What roles are Eurasian banks expected to play?
  - Banks play significant roles in Eurasia. Market discipline via securities market is not yet sufficient.

- Banks' **assessment & monitoring** on corporate **borrower's** CG should be encouraged (as an important part of risk management)
  - Will benefit banks themselves as far as the borrower's CG affects its credit worthiness
  - **Policy tool** to improve national CG standards

- But banks' arbitrary intervention is not desirable
  - Banks' request on corporate borrowers' CG should be specified in **covenants, depending on the borrowers size.**

Chapter 10. The role of supervisors and the next steps

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

Empower the board (1/5)

- The boards (supervisory boards) should play a critically important role in bank governance.

- *"Together with guiding corporate strategy, the boards are chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands of relevant stakeholders"* (OECD Principles).

Empower the board (2/5)

Effective boards need **information**

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

Empower the board (3/5)

Effective board needs **capability**

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

Empower the board (4/5)

Effective board need **independence**

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

Empower the board (5/5)

Effective board needs **power within the bank**

- [Para #30] Supervisory board should at least propose **appointments/removals** of management board members at general shareholder meeting even if laws provide shareholders with the appointments/removals power.

- [Para #37] “Revision Commissions” may be **diluting** board’s responsibility and power

Hard Law & Soft Law
- appropriate balance - (1/5)

- Banking supervision has traditionally been based on laws and regulations (**Hard Law**) covering a wide range of subjects.

- More **Effective & precise** regulations (especially prudential oversight of capital, liquidity & risk mgt.) is increasingly need.

- Nevertheless, **direct** regulations & supervisions are not a panacea.

Hard Law & Soft Law
- appropriate balance - (2/5)

- For instance,

  Basel II: Besides the minimum regulatory capital ratios (pillar 1. traditional approach), there are two new pillars to accompany it.
  - Pillar 2: **Efforts by banks** to assess their capital adequacy and by supervisors to review such assessment (supervisory review)
  - Pillar 3: Banks' **public disclosures** that lend greater insight into their capital adequacy (market discipline)

- More **emphasis** is needed on good bank **governance** in which banks are expected to pursue sound banking.

Hard Law & Soft Law
- appropriate balance - (3/5)

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

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

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

Hard Law & Soft Law
- appropriate balance - (4/5)

- Why do many countries use **Soft Law** as well?

  For instance,

  – One-size-fits-all is often **not** effective for CG issues
  – Easy to revise, **flexible** for ever-changing circumstances, and allows **experimentation** & innovation
  – Allows **principles-based** approach. No "*show me where it says we cannot do it*" mentality
  – Less regulatory **costs**
  – Allows **bottom-up, pragmatic** approach and **process**

- Voluntary governance codes with "**comply or explain**" basis are recommended

Hard Law & Soft Law
- appropriate balance - (5/5)

- "**Comply or explain**" codes
  - As purely voluntary, private sector recommendations
  - As stock exchange rules/guidelines/recommendations (e.g. **listing requirements**)
  - Developed by, or by the **support/initiative** of, governmental agencies
  - With some **legal backing** (e.g. Company Law refers to the codes)

- Governance codes specifically applied to **banks**
  - Based on which an **individual bank** can develop its own codes/policies

Thank you very much.

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