



European Bank
for Reconstruction and Development

Corporate Governance of Banks in Eurasia

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Policy Brief

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The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its Member countries or the European Bank for Reconstruction and Development

- Introduction
 - Bank Governance Review (BGR) Methodology
 - Main Findings and Policy Recommendations
 - Next Steps in our Review Process



IFC/WB Corporate Governance Department

Global Corporate Governance Forum

- Raising awareness and building consensus
- Disseminating Best Practices
- Sponsoring Research
- Supporting TA and capacity building

Corporate Governance Policy Practice

- Diagnostics:
- ROSC assessments
 - Banking sector (BIS)
 - SOE governance
 - Islamic banks (2008)
 - Support WB operations
 - Publishes best practice papers

Investor and Corporate Practice

- Evaluates client companies
- Uses IFC methodology
- Set of tools and practices
- Helps clients implement best practice
- Provides technical assistance



Introduction: What we do...

In order to respond to growing country requests, a set of operational tools was developed.

The review tools include:

- a set of operational benchmarks
- a toolkit to collect relevant information; and
- a methodology to establish the review process

Country Reviews:

- 6 country reviews completed in 4 different regions of the World
- 4 more country review in the pipeline for FY 09



- Introduction
- **Bank Governance Review (BGR) Methodology**
- Main Findings and Policy Recommendations
- Conclusions

Benchmarks: Sources...

- **BASEL**
 - Basel BGR Guidelines, 1999
 - Basel Core Principles
 - Basel II Capital Accord, 2004
 - Basel BGR Principles, 2006
- **Office of the Comptroller of the Currency (OCC) (US)**
 - Various publications and examination procedures
- **WORLD BANK**
 - BGR Template, existing
 - Corporate Governance ROSC, 2005
- **EUROPEAN UNION**
 - EU CG Action Plan
 - EU Directives
 - C-EBS Publications
- **APEC**
 - Corporate Governance Guidelines, 2004
- **MOODY'S**
 - Risk Management Assessment, 2004



- **BASEL**
 - Subcommittee for the revision of BGR 1999 Guidelines
- **OECD**
 - Corporate Affairs Division
- **EU COMMISSION**
 - DG Internal Market Unit - Banking and financial conglomerates; Regulatory Peer Review



A. Board Function	A.1 Roles and Responsibilities A.2 Fiduciary Duty A.3 Composition, Qualifications, Compensation & Performance A.4 Related-Party Transactions. A.5 Participation in Financial or Non-financial Groups
B. Senior Management	B.1 Roles and Responsibilities B.2 Accountability B.3 Conflict of interest—Related-Party Transactions B.4 Management in Financial or Non-financial Groups
C. Internal Review and Monitoring Functions	C.1 Risk Management Function C.2 Compliance Function C.3 Internal Audit Function C.4 Internal Alert Procedures
D. External Audit Function	D. External audit function
E. Disclosure, Transparency & Market Discipline	E. Disclosure, Transparency & Market Discipline
F. Banking Supervision	F.1 Legal authority F.2 Corporate governance oversight F.3 External audit and internal review function F.4 Evaluation of group structures

- Designed Tools to elicit legal and regulatory information on country's aspects of bank governance:
 - “Bank Supervisory Questionnaire” (to be completed by the Bank Supervisor) to elicit market practice information related to the sector
 - “Legal and regulatory Framework Information Request” (To be completed by the Legal/Research Department of the Central Bank) to collect information on:
 - Legal and regulatory framework
 - Judicial system
 - Accounting and auditing standards



But...can you guess the company?

Size	<ul style="list-style-type: none">• Appropriate size – 15 directors
Independence	<ul style="list-style-type: none">• Over 70% outside directors• Separated role of chairman and CEO• 5 sub-committees (executive, finance, audit, compliance, compensation, and nominating)
Diversity	<ul style="list-style-type: none">• 4 professors / directors of academic institutions and 6 current or former chairmen / CEOs of companies.• Backgrounds in accounting, medicine, trading, technology, petroleum and gas, and banking.
Experience	<ul style="list-style-type: none">• Several directors had more than 20 years of experience; in total board members had more than 140 years of experience• Many directors served on boards of other blue chip companies as well.



The BGR Methodology

private sector development

But...can you guess the company?

December
2001:
Enron files for
bankruptcy

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Source: McKinsey

Toolkit was refined to better capture corporate governance practices:

- **A Survey of selected banks, capturing measures of:**
 - Composition of the Board
 - Professional background of board members
 - Remuneration schemes
 - Board commitment to duties
 - Board attendance
 - Board MIS (package etc.)
 - Strategy approval criteria
 - Board self-evaluation policies
- **Questions to further elicit board risk management practices:**
 - What are the risks your bank is facing?
 - Why are you facing these kinds of risks?
 - How do you intend to mitigate them?
 - Why have you chosen this course of action?
- **Bank Specific Financial Indicators Request**

The added value of the review methodology is to capture what is actually happening in the banking sector



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Main Findings

1. Blurred lines of responsibilities and authorities

- Legal framework's definitions on role of board and management tend to be incomplete (codes often try to fill that gap)
- Board & management do not always understand their role (or the business / risk profile of the bank)
- Independence of board members not clearly defined or misunderstood by market participants.



Policy Recommendations

1. Blurred lines of responsibilities and authorities

- Clarify in the legal framework (especially in civil law countries) roles and responsibilities of board and management.
- Draft/enhance regulations, guidance to include:
 - Clear responsibilities of board and management to understand the business / risk profile of the bank
 - Clear definition of independence
 - Board performance evaluation
 - Limit number of outside directorate commitments



2. Ownership opaqueness

- The supervisors and the market often claim to know who the beneficial or ultimate owners of banks are...
...BUT it's hard to get a clear ownership structure from the public information readily available.
- Adequate fit & proper tests for owners are not often in place

Policy Recommendations

2. Ownership opaqueness

- Disclosure requirements should include identification of cross shareholding
- Introduce ownership approval thresholds and specify fit and proper vetting.

Main Findings

3. Limited scope of Related Party Regimes

- If owners are not identified or identifiable , related party transactions are difficult to monitor.
- RT Regimes are often related to connected parties / borrower groups under the large exposures provisions and often do not capture all material transactions.
- In case of conglomerates, the related party provisions should also include disclosures of transactions with other companies in the group.



Policy Recommendations

3. Limited scope of Related Party Regimes

- Ensure set up (via internal policy) of monitoring systems for RPTs and clear definition of RPTs.
- Capture (via internal policy) all Related party transactions in the definition, including controlling and controlled companies.



Main Findings

4. Lack of independence of internal monitoring functions

- Not often adequately staffed and funded
- Internal audit function needs to be elevated within many banks, with more serious emphasis on role of the audit committee.
- Risk management, compliance, internal audit are not often part of the strategic planning process, especially for business expansion & new products
- Compliance function not fully developed (often misunderstood with AML monitoring); a cooling off period for bank supervisors entering the private banking sector is often missing.
- Risk management - often lagging behind, and not structured based on market growth and core business lines of the institutions



Policy Recommendations

4. Lack of independence of internal monitoring functions

- The resources allocated for internal review functions should be made an integral part of the planning process.
- Clearly define in internal policies reporting lines of internal monitoring functions
- Develop risk management systems tailored to core business lines of the institutions



Main Findings

5. Supervisory Challenges

- Supervisory tools to address opaque ownership structures need to be expanded
- Well-established channels of communications with board members are often missing
- In sectors populated by financial conglomerates, sharing of sensitive information among supervisors is often missing



5. Supervisory Challenges

- Hold the board accountable for critical governance issues and require timely corrective measures
- Consider issuing guidance to banks on sound corporate governance
- Ensure signing of formal MoU with other domestic and foreign supervisors for sharing of information



In Summary...

- Effective bank governance cannot be legislated.
- Achieving regulatory requirements should be seen as a starting point, not an end goal
- Sound bank governance is an attitude, a way of doing things, and the manner in which owners, directors, & management fulfill their public trust.



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Review Process

Next Steps:

- Convert the questionnaires into a professional survey instrument.
- Develop a higher level, more brief alternative to a full-scale review.
- Build a bank governance legal and regulatory database

