The Assessment of Corporate Governance in Banks: from Principles to Practice

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Outline

A. Critical Role of Effective Governance in Banks
B. Key Findings Bank Governance Country Reviews
C. Role of the Supervisor and Supervisory Framework
D. Bank Governance Assessment Tools
E. World Bank Assistance Program
A. Critical Role of Effective Governance in Banks

Governance is about what people in responsible positions do (or don’t do) with other people’s money...

- Critical role in the economy
- Increasing complexity of bank activities
- Need to safeguard depositors’ funds
- Sensitivity to liquidity crises
- Importance of trust and confidence
B. Key Findings from Country Reviews
Selected Highlights

1. Fundamental Understanding
2. Ownership, “fit & proper”
3. Composition, qualification of Managing Bodies
4. Audit Committee Function: Qualified & Independent
5. Oversight & monitoring function
6. Disclosure & transparency

Sound Bank Governance
1. Fundamental Understanding
(lack of) Sound Bank Governance

Banks are considered “public interest entities”.

Through the taking of deposits, dealing with customers, and facilitating funds flow through the economy, owners, directors, senior mgmt. assume responsibility for the “public trust” - first.

Boards & management must embed this fundamental understanding in the banks’ culture and decision-making processes.
2. Bank Ownership, Organizational Structures and “Fit & Proper”

- Beneficial or ultimate owners and organizational structures should be known, at a minimum to supervisor, to facilitate evaluation by stakeholders.

- Clear lines of authority and responsibility should be established between the boards and senior management and role of controlling the shareholders.

- “Fit & Proper” Members of Banks’ managing bodies (BOD, SM) should be ensured.

- Identification of direct and indirect related party transactions.
3. Composition and Qualifications of Managing Bodies

- Members of Managing Bodies should be able to:
  - Understand the dynamic **risk profile** of bank
  - Be **qualified**, updated as complexity of the bank grows, and not be over-committed
  - Be **independent** in judgment from the controlling owners and other external influences

- Board remuneration should be **linked** to L-T banks’ performance and not, for example, to remuneration of senior management
- Senior management **succession planning** is a concept that needs to be fully embraced
- Subsidiary boards of largely foreign owned banks should be required to **act in the best interests of the bank** and have qualified, independent local representation

**Governance structures need to keep pace with bank & market changes, particularly as new unidentified risks may accumulate and be masked by corresponding (initial) revenue growth**
4. Audit Committee Function: Qualified & Independent

- Good practice: comprised of non-executive directors, independent directors and have updated, pertinent skills
- Former senior officials from supervisory agencies, subsequently employed by banks, should be disallowed from making representations on supervisory matters pertaining to the bank
- Independently receive audit results & management's corrective actions
- Responsible for accuracy of financial reporting (together with full board)
- Ensure proper review of “special structures”
- Promote independence / elevate internal audit
- Adequately fund external and internal audit

Long-standing directors on board and audit committees may not have updated skills for the review of audits, risks, and related issues; The responsibility for & the importance of financial statement accuracy may not be fully realized by bank parties.
5. Oversight and Monitoring Functions
(risk management, compliance, internal audit)

- **Planning for internal review functions** >>> inherent part of strategic planning, especially for business expansion & new products
- **Adequately** staffed and funded
- **Independent** from the business line they monitor
- Internal audit function: **elevation** within bank, more serious **emphasis** by management and Audit Committees
- **Related party transactions**: define, identify, approve (board) and monitor

The degree of development of internal review functions is quite wide ranging, usually a function of international activity and/or desire for increased efficiency and profitability.
6. Disclosure & Transparency

- **Accuracy and integrity** of financial statement (incl. supporting notes & disclosures) and management information > key indicator of governance status of a bank

- Disclosure of **full financial statements**, including supporting notes; websites should be informative, including full financial statements

- **Qualitative disclosures** provide marketplace with additional information with which to judge governance status, including:
  - significant shareholders / ownership structure
  - related party & affiliate transactions
  - Codes of ethics / governance

- Activities in **jurisdictions that impede transparency** and activities through complex structures need particular attention

Under an inadequate framework, governance issues may remain unreported unless uncovered by the supervisor during the examination.
Role of the Supervisor and Supervisory Framework

- The supervisory function is key to the promotion and diligence of sound bank governance.
- Tools of Supervisor to address opaque ownership structure need to be expanded.
- Legal framework need to be balanced to avoid significant regulatory burden (rules-based) of new BG requirements.
- Market oversight, particularly in the securities trading, financial accuracy, and board liability areas, need strengthening.
- Effective related party transaction regimes need to be enforced.
- The effectiveness of enforcement actions, if and when taken, should be clear, particularly in transactions such as mergers.
- Governance of supervisory agencies.
D. Bank Governance Assessment Tools
Development of an Assessment Tool, 2005-2006

1Q 2005

Initial Template

Basis: regulatory and IFI resources (Basel, ROSC Templates, EU Legislation, C-EBS publications, APEC Guidelines, various supervisory issuances) and private sector initiatives (Moody’s RMA, Fitch).

2Q 2005

First Reviews

Questionnaire to collect info about domestic bank governance & related supervisory practices

Guidance: Basel Guidelines

3Q 2005

Revised Approach

4Q 2005-2Q 2006

Recent Reviews

Additional tools:
- Questionnaire for selected banks re: practice*
- Guidelines and report format anchored in Basel BG Principles*

*Reference: IFC Bank Questionnaire, C-EBS new publications, APRA, OCC, OSFI
Approach and BG Assessment Tools

- **BG Assessment “Toolkit”:**
  - Guidelines and Methodology
  - Bank Specific Questionnaire
  - Questionnaire to Domestic Bank Supervisor

- **Process Reviews:**
  - World Bank internal review
  - (Informal) Basel Working Group for BG (through WB participation in group)

- **Refinement of Tools ongoing**

- **Output of Review** – “Technical Note” focuses on bank governance specific issues; focus on selected banking practice
Bank Governance in Practice – Key Message

- Are the tools a “magic answer” to identify weaknesses in bank governance?

- NO. The bank governance review intends to provide a powerful apparatus to initiate **fundamental cultural changes** required to upgrade governance environment by addressing

  - **Quantitative framework, or, “hardware”:** legal and institutional structure. Governance indicators may convey a different setting than that which exists (“measuring against tick-boxes”)

    ...but also

  - **Qualitative aspects, or, the “software”:** actual practice, implementation.

Effective bank governance cannot be entirely legislated...

... it is about what people in responsible positions do or don’t do with other people’s money.
Thank you.

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