# Policy Brief on Corporate Governance of Banks in Eurasia
# (First Draft)

## Table of Contents

## Background

1. The Eurasian Corporate Governance Roundtable ("Roundtable")[1] organised by the OECD (Organisation for Economic Co-operation and Development) serves as a regional forum for structured policy dialogue on corporate governance. Participants of the Roundtable from the Eurasian region included those from Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Mongolia, Ukraine and Uzbekistan. In 2004, the Roundtable presented "*Corporate Governance in Eurasia; A Comparative Overview"* ("Roundtable Comparative Report")[2] which provided region-specific priorities and recommendations for reform to assist policy makers, regulators, stock exchanges, and other standard-setting bodies in Eurasian countries.

2. The Roundtable Comparative Report identified corporate governance of banks as one of the priorities for reform and recommended that, "governments should intensify their efforts to improve the regulation and corporate governance of banks" (Roundtable Comparative Report, pp. 12-13). Responding to this, at its 2006 meeting in Istanbul, the Roundtable decided to establish a task force which is to report back to a future Roundtable meeting with a policy options paper ("policy brief") addressing corporate governance challenges shared by banks in Eurasia. The policy brief is to focus on policy issues and options and in turn will support efforts in Roundtable countries to improve corporate governance of banks in their jurisdictions.

3. This policy brief has been developed through active discussion within the Task Force on Corporate Governance of Banks in Eurasia ("Task Force"). The Task Force includes experts from the nine Eurasian countries mentioned above and an expert from Tajikistan. It also includes experts from some OECD member countries and international organisations. The OECD with the support of EBRD (European Bank for Reconstruction and Development) served as a secretariat for the Task Force. It should be noted in particular that the Task Force comprises both experts in banking and capital markets who had each been discussing this topic separately. While all members of the Task Force occupy senior positions in their respective organisations,

[1] http://www.oecd.org/document/38/0,2340,en_2649_37439_2048422_1_1_1_37439,00.html

[2] http://www.oecd.org/dataoecd/18/63/33970662.pdf

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. It does not address, either, with some exceptions, many 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")[3], the Comparative Report and the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* ("SOE Guidelines")[4]. 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 Basel Committee on Banking Supervision has revised its guidance on *Enhancing Corporate Governance for Banking Organisations* ("Basel CG Guidance")[5]. 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 develop any form of different international standard, but is more concerned with effective implementation of existing norms. The discussion of the Task Force has drawn on them for guidance, and the first seven chapters of the recommendation section of the policy brief actually correspond to the first seven principles of the Basel CG Guidance while reflecting the Eurasian context.

6. There are a lot of 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 organisations such

[3] http://www.oecd.org/document/49/0,2340,en_2649_37439_31530865_1_1_1_37439,00.html

[4] http://www.oecd.org/document/33/0,2340,en_2649_34847_34046561_1_1_1_1,00.html

[5] http://www.bis.org/press/p050729a.htm

as banking industry associations or institutes of directors often play an important role in assisting boards and senior management of banks to fulfill their responsibilities. Banking supervisors have the responsibility to provide a regulatory framework and guidance in terms of corporate governance of banks, and 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.

## Introduction

7. Effective corporate governance practices of banks are essential to maintaining the sound and proper functioning of the banking sector. The reasons why bank corporate governance is important would, therefore, mostly overlap the reasons why sound and proper banking must be secured. There has been much accumulated discussion in the world on the necessity of sound and proper banking; it would usually include those arguments which focus on the critical functions that should be properly performed by banks in deposit taking, credit allocation and payment systems. In other words, it is often argued that bank failure might involve systemic risks and cause huge negative impact on depositors, other stakeholders and economy as a whole[6]. The Task Force agrees on these arguments that are now commonly shared by banking supervisors around the world and thus would not reiterate here the arguments on the necessity of proper and sound banking or on the importance of bank governance.

8. Apart from the arguments above, however, there is an additional reason why bank corporate governance should be enhanced in the Eurasian context. The banking sector is one of the most advanced, well-organised industries in many Eurasian countries. Furthermore, banks often occupy a position in which they can, if they wish, seek to influence corporate governance of their company borrowers. From the viewpoint of ensuring sustainable economic development in transition economies, banks in Eurasia are expected, if not forced, to become role models for other companies in implementing better corporate governance.

9. In order to improve bank corporate governance in Eurasia, the following chapters propose various policy options that can be implemented by policy makers and banks in the region. Based on well-known international standards such as those of the OECD and Basel Committee on Banking Supervision, the discussion of the Task Force has been developed in Eurasian context. Some general aspects of the policy brief in relation to the Eurasian context should be noted at the outset.

[6] It does not mean individual banks should be protected.

10. Firstly, a lot of Eurasian countries are referred to as having dual board structures. In practice, however, dual board structures typically seen in continental European countries and the internationally widespread unitary board structures do converge because of the intensive interaction of the upper boards and lower boards in dual board structures. Furthermore, the role of lower boards in Eurasian countries is often limited to day-to-day management. Unlike the typical dual boards in Germany or Austria, the lower boards in Eurasia are not legally expected to jointly establish, together with the upper boards, corporate objectives, strategies or fundamental policies. In that sense, the function of most Eurasian dual boards may be close to that of a unitary board system that has, in addition to a board, an executive meeting, though not as a statutory body. Against this background, similar to the OECD Principles and Basel CG Guidance, the term "board" and "senior management" as used in this document are not to identify specific legal constructs, neither dual boards nor unitary boards, but rather to label supervisory functions and management functions, respectively. Instead, supplementary explanations for clarification which are specifically applicable to the dual board structures are often made where appropriate.

11. Secondly, in many Eurasian countries, whether they adopt dual board or unitary board structures, banks or joint stock companies in general are legally required to have another statutory body[7] responsible for internal audit or supervisory functions. Organisational structures, functions or responsibilities of these statutory bodies are not necessarily identical across these countries; in many countries they are collegial bodies but in others they can be one-person bodies as an option, and their functions and responsibilities can either be limited to financial audit purpose or rather broader ones including compliance functions. However, the members of these bodies are legally required to be directly elected/appointed at the general shareholders meetings and the members of such bodies are legally prohibited to concurrently serve as members of the boards or executive bodies. Laws provide them with separate powers and responsibilities from those of boards and therefore they are not under the auspices of the boards. They are not just an internal unit/department for internal audit because they do not report to the boards or management. Such a governing structure is one of the major characteristics in Eurasia, if not unique to the region[8]. It is sometime confusing to foreigners because these statutory bodies are often translated into English

[7] They are of course different from general shareholders meetings or external auditors.

[8] Similar examples can be seen in Russia and East Asia, for instance.

as “Supervisory Board”, “Audit Committee”, or “Auditing Commission”, but they are neither boards nor boards’ committees. This policy brief provisionally calls them “*Revision Commissions*” and tries to discuss their responsibilities where appropriate. The *Revision Commissions* can be seen at least in Armenia, Azerbaijan, Georgia, Moldova, Mongolia, Ukraine and Uzbekistan.

## Chapter 1; Boards, board members and specialised committees

This chapter relates to Principle 1 and its annotations of the Basel CG Guidance; "*Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.*"

12. The highest authority in terms of major company decisions ultimately rests with general shareholders meetings, not with boards, and actual operations of companies, on the other hand, are carried out by senior management and employees, not by the boards, either. Nevertheless, in virtually all countries in the world, **the boards (or the upper boards in dual boards systems) are increasingly expected to serve as a key fulcrum in corporate governance.** Together with guiding corporate strategy, the boards (or upper boards) are chiefly responsible[9] for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands of relevant stakeholders. The board members owe fiduciary duties (i.e., the duty of care and the duty of loyalty) to shareholders. In terms of banks, the bank boards should also be aware of their responsibilities to depositors including the general public who entrust their everyday savings.

13. In order for the bank boards (or upper boards) to exercise objective judgment, it would usually be required that a sufficient number of board (or upper board) members be independent from management. Although in dual board systems the upper board is by law non-executive, the "independent directors" are not just the non-executive directors. The best practice seen in the OECD member countries now seems to require **the independence from senior management in which independent directors cannot be affiliated with the senior management in terms of former employment, material business relationship, additional remuneration from the company, close family ties or cross directorship.** Furthermore, the best practice seen in the OECD countries that adopt dual board systems also imposes some **restrictions on former lower board members when they serve as upper board**

[9] The responsibilities of the boards are further mentioned in the following chapters.

**members.** For instance, the numbers of such members are limited to a certain level and these members in principle cannot become the chairman of the upper board or board's committees (if they do, the reason should be explained to shareholders).

14. Moreover, the national corporate governance codes in more than one third of the OECD member countries, including those who adopt dual board systems, are now also concerned with **the independence from a major shareholder** underlining the reality that in many countries there is a strong relation between management and a major shareholder. The degree to which such independent directors are needed would depend on national conditions, and there seems to be strong necessity in most Eurasian countries as the OECD Principles[10] explain that the independence from controlling shareholders will need to be emphasized, in particular if the *ex-ante* rights of minority shareholders are weak and opportunities to obtain redress are limited.

15. How many *independent* directors should be required would also depend on national conditions. The best practices in OECD member countries vary from the Netherlands where all upper board members except one person should be independent directors, to Germany where there is no quantitative standard in terms of minimum number/proportion of the independent directors. It would be inappropriate to suggest a "one size fits all" answer for Eurasian countries, but in any case, **Eurasian banks should be required to have a sufficient number of independent directors who are independent from both management and controlling shareholders.**

16. In some OECD member countries where market pressure functions well, the independent directors are required by national codes of corporate governance, not by direct regulations. **These codes are implemented on what is called "comply or explain" basis on which companies that do not comply with the requirements have to clearly explain the reasons of non-compliance to their shareholders.** Although the comply or explain approach is basically recommendable, direct

[10] Annotations to Principle VI E.

regulations[11] may be a natural option for some Eurasian countries where market pressure or shareholders' monitoring function is not yet sufficiently strong.

17. Each member of senior management (or lower boards) in charge of banks' day-to-day operations ought to have sufficient skills and experience in banking before appointment. On the other hand, **the boards (or upper boards) should have adequate collective knowledge of the material financial activities the bank pursues. They also need the collective knowledge and expertise necessary for effective governance and oversight.** It does not mean every member of the boards (or upper boards) ought to have detailed knowledge before appointment but in any case banks are encouraged to implement programs of ongoing education for the members of the boards (or upper boards). Banking supervisors and/or banking industry associations, in cooperation with international organisations where available and appropriate, should help banks implement such programs or even provide training programs themselves. It is recommended that **the programs should include those which would provide full understanding and awareness of the responsibilities of the boards in terms of corporate governance.**

18. Many OECD member countries, especially those with a unitary board combining oversight and management functions, found it beneficial to establish certain specialized committees. These committees are usually established within/under the boards (or upper boards) so that they can enhance the function of the boards (or upper boards) by mobilizing boards' experts into intensive, small-group discussion as well as by assuring, when independent directors play key roles in the committees, impartial judgment.

19. The Basel CG Guidance recommends that **banks should "have an audit committee or equivalent structure responsible for similar functions".** It typically is responsible for providing oversight of the bank's internal and external auditors;

[11] The regulation approach may suit banks in particular because their autonomy would naturally be more limited than that of non financial companies.

approving[12] the appointment, compensation and dismissal of external auditors; reviewing and approving audit scope and frequency; receiving audit reports; and ensuring that management is taking appropriate corrective actions to address control weakness and non-compliance. In Eurasian countries where laws require the establishment of *"Revision Commissions"* (see paragraph 11) responsible for internal auditing functions, simply establishing another committee may be confusing and might rather obscure the line of responsibilities. As long as these countries maintain the *"Revision Commissions"*, an option in order for them to achieve policy goals similar to those by establishing the board's audit committees would be to **fully activate the function and enhance the independence of the *"Revision Commissions"* while encouraging the collaboration between the *"Revision Commissions"* and the boards (or upper boards) who should occupy a central position in overseeing management.** (See Chapter 5 for utilizing the "Revision Commission"). If it seems difficult to bring truly effective "Revision Commissions" to realization, **an option for policy makers would then include abolishing[13] them and integrating their powers to the new board's audit committees by revising banking laws.**

20. Credit committees, risk management committees and ALM committees are seen in many, if not all, Eurasian banks and are actually recommendable. In order to consolidate necessary powers to the boards (or upper boards) who should play key roles in corporate governance, **these committees would naturally be established as board's (or upper board's) committees.** Nomination committees are also prevalent in other part of the world but not in Eurasian banks. **Nomination committees, and, where appropriate, remuneration committees, are strongly recommended to be established.** Further discussion on this point will be made on Chapter 3.

[12] Or recommending to the boards (or shareholders) for their approval in the jurisdictions where laws provide the entire boards (or general shareholders meetings) with the legal power to approve it.

[13] As shown in Chapter 5, some OECD countries found it unrealistic to make such bodies, in addition to the boards, really effective, and thus have been revising company laws.

## Chapter 2; Bank's strategic objectives, corporate values and high standards of professional conduct that address conflicts of interest and unethical behaviors

This chapter relates to Principle 2 and its annotations of the Basel CG Guidance; "*The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.*"

21. Banks in Eurasian region, at least large ones, usually develop bank strategy, values, and major plans of action into documents that are necessary to conduct the activities of any organisation. Bank boards (or upper boards) should be responsible for reviewing and guiding them, and most laws in the region actually stipulate this. In so doing, however, active involvement and contribution by management (or lower boards) is indispensable for making them really practical and enforceable. The risk of building castles in the air would therefore probably be smaller in unitary boards that include executive board members than in dual boards. Some corporate governance codes in OECD member countries with dual board systems (e.g., Germany, Austria and the Netherlands) clearly require lower boards to contribute to upper boards that approve the strategies, etc. and thus are successful in avoiding such a risk. Although laws in Eurasian countries with dual board systems do not explicitly cover the role of the lower boards on this, this should not be construed as the laws ban necessary contribution by the lower boards on this; **the upper boards should be able to receive whatever support and suggestions necessary, including developing preliminary drafts when appropriate, from the lower boards. Regulations or national corporate governance codes should clarify this for banks.**

22. The most difficult part, however, would normally rest with nurturing the bank culture in which senior management and bank employees really understand and comply with the strategic objectives and values, including those regarding ethics and compliance rules, rather than developing them into documents. There is no magic answer for this but, in any event, **the boards (or upper boards) should be primarily responsible for ensuring that such a culture prevails throughout the banks.** The boards (or upper boards) should ensure that, through management, awareness-raising programs are provided for bank employees and that bank employees are promoted or punished in

accordance with their conformity to the objectives and values as one of the key elements of assessments. The members of the boards (or upper boards) should be role models for management and employees in implementing the objectives and values. They should constantly check if the objectives and values are actually prevailing throughout banks by analysing major incidents in which bank employees failed to meet the objectives and values.

23. In order to ensure that corporate values, especially those related to ethics and compliance function, prevail throughout banks, **it is important for the boards (or upper boards) to encourage the reporting of unethical/unlawful behavior without fear of retribution.** The bank boards (or upper boards) should clearly indicate a contact point for employees who wish to communicate concerns and assure them of the confidentiality as well as their protection. The contact can either be a person inside or outside of the bank designated by the boards (or upper boards), or a bank employee at the internal control department (or who works for the "*Revision Commissions"*), but in any case he/she should be independent from management. It is true that such "whistle blowing" has been rare in many Eurasian countries but it should be noted that some countries in other regions who do not have such tradition either have nevertheless moved to the phase in which they recently developed a law on protection of the whistle blowers. Banking supervisors may not be in charge of drafting/developing such general protection laws but **they should at least take necessary measures so that bank employees can freely communicate their legitimate concerns.**

24. The second Principle of the Basel CG Guidance allocates a large portion of its annotations to controlling conflicts of interests including related-party transactions. This would be a natural outcome of the fact that preventing abusive related-party transactions in banks is an important policy goal for ensuring sound banking. Banking supervisors in Eurasia seem to think such transactions, especially those between banks and shareholders, or banks and company groups, need particular attention. In most cases, they have already developed various regulations in relation to this. However, ensuring the appropriate implementation and enforcement of such regulations can be the most challenging part.

25. Theoretically, related-party transactions are not harmful as far as they are made on market terms and conditions. However, it is not always clear in practice if a transaction is made on an arm's length basis especially when there are many factors to be considered including the estimation of the risk of borrowers which requires technical skills and may be easily underestimated. In any case, the boards (or upper boards) should be fully responsible for ensuring that the rules and procedures on the related- party transactions are effectively in place. **They should also approve (or disapprove) materially important transactions respectively while requiring management to clearly prove that they are on market terms and conditions.** A committee of the boards (or upper boards), whether it is called audit committee, risk management committee, credit committee or other, can be useful for this purpose as far as it consists of independent directors and those who have expertise in bank finance. **Regulations should require that materially important related-party transactions be disclosed and reported to the banking supervisors**.

26. In addition to the measures mentioned above, **another option can be the outright banning of certain, limited types of related-party transactions.** These may include a ban on personal lending to the board members, senior management, controlling shareholders, and their close relatives, possibly with exceptions on some standardized lending such as housing loans.

## Chapter 3; Clear lines of responsibilities and accountability

This chapter relates to Principle 3 and its annotations of the Basel CG Guidance; "*The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization.*"

27. It is important for the boards (or upper boards) to clearly define the authorities and key responsibilities for themselves, senor management (including lower boards) and others. Unspecified lines of accountability or confusing, multiple lines of responsibility may create a vacuum in which nobody is fully in charge. In order to avoid such a risk, **the boards (or upper boards) ought to have an overall and ultimate responsibility in overseeing management's actions, and thus, they should be granted supreme powers over senior management (including lower boards).**

28. It should be noted that in some Eurasian countries, laws require the members of the lower boards be appointed at the general shareholders meeting. Although it means that these laws provide strong power to the shareholders, the question here is, can people (upper boards) effectively control others (lower boards) without having any influence over their appointments and removal[14]? Arguably, that is why virtually all OECD member countries with dual boards systems adopt either of the following frameworks; (i) upper boards have the legal power to appoint and remove lower boards, (ii) upper boards have the legal power to nominate lower boards when they are appointed by general shareholders meeting, or, at least, (iii) laws permit upper boards to appoint lower boards if the articles of association stipulate so. As far as banks are concerned, the boards (or upper boards) backed by professionalism which include both experts and independent members are usually in a better position than shareholders to oversee the management especially because banking is a highly technical and complex business, and, thus, they should be granted necessary powers for this. For Eurasian countries where laws require general shareholders meetings exclusively to appoint lower boards, it might be advisable to start reviewing if such a statutory framework is

[14] In some other countries that adopt similar frameworks, Indonesia, for instance, the upper boards are said to have difficulties in effectively controllin the lower boards due to their lack of power in relation to the appointment.

the best, but, in the meantime, at least, **banking supervisors should promote the practice in which upper boards of banks nominate lower boards' members.**

29. For the Eurasian countries who adopt the *"Revision Commissions"*, clear and proper allocation of responsibilities also needs to be ensured between them and the boards (or upper boards). This will be further discussed in Chapter 5.

## Chapter 4; Oversight by senior management and internal control functions

This chapter relates to Principle 4 and its annotations of the Basel CG Guidance; "*The board should ensure that there is appropriate oversight by senior management consistent with board policy.*"

30. Internal control is a process, effected by a company's board, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (i) effectiveness and efficiency of operations (Performance objectives), (ii) reliability and timeliness of financial and non-financial reporting (Information objectives), and (iii) compliance with applicable laws and regulations (Compliance objectives). In varying degrees, it is the responsibility of everyone in banks.

31. An effective internal control will be achieved on a bank culture established by the boards and senior management which emphasises and demonstrates to all levels of personnel the importance of internal controls. **In addition to a periodic evaluation[15] made by the internal audit and often by external auditors, banks should continuously monitor and evaluate the effectiveness of their own internal controls.** It is the responsibility of the management to establish and improve banks' internal control systems based on the evaluation. **The boards (or upper boards) should guide management on this and ensure that the management establishes appropriate internal controls.** A document made public by the Basel committee, "*Framework for Internal Control Systems in Banking Organisations*", would provide valuable suggestions for banks to establish and improve their internal controls as well as for banking supervisors to evaluate the effectiveness of banks' internal controls.

[15] The periodic evaluation will be discussed further in the next chapter.

## Chapter 5; Internal audit and external auditors

This chapter relates to Principle 5 and its annotations of the Basel CG Guidance; "*The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.*"

32. The internal audit function in many Eurasian countries is characterized by the *"Revision Commissions"* that are directly in charge of the internal audit function or instruct the internal audit units/divisions/departments. They are separate bodies from the boards or managements and the members are appointed at the general shareholders meetings. Although theoretically such a framework is expected to have a merit in ensuring the independent function of the internal audit, examples in some countries in other part of the world show that it might include some demerits. The statutory corporate bodies that play similar roles in Korea have been criticized as being just formalities that do not have the necessary power in reality. It is also said that it is often difficult in practice to figure out which organs, the bodies or the boards, are responsibilities for certain roles. Korea has recently revised its company law; banks or large companies are no longer allowed to have such bodies and instead they are legally required to establish boards' audit committees, which provides the boards with more integrated powers. There have also been criticisms in Japan about the effectiveness of similar bodies that Japan's company law had traditionally required for more than a hundred years. The company law in its recent revision finally made it optional for large companies to keep the bodies or abolish them and instead establish boards' audit committees.

33. It is inappropriate to suggest a one-size-fits-all solution simply because other countries have problems with similar systems; it is the responsibility of national policy makers and regulators to check whether the framework is really working or not. For instance, there seems to be a risk in which the *"Revision Commissions"* are single-mindedly focusing on minor errors, unable to tackle bigger problems. If they do not seem to be working effectively in reality, **some options below may serve as reference points in improving the situation;**

(i) Mandatory inclusion of "independent" members to the *"Revision Commissions"* who have never worked for the company nor have specific ties to controlling shareholders,

(ii) Mandatory inclusion of full-time members,

(iii) Mandatory inclusion of members with expertise in accounting,

(iv) Statutory nomination process of the members of the *"Revision Commissions"* in which the *"Revision Commissions"* themselves have a say,

(v) Statutory rights of the *"Revision Commissions"* to request the necessary costs for their task in addition to their ordinary remuneration,

(vi) Statutory obligation for the management to submit documents requested by the *"Revision Commissions"* and provide necessary explanation.

(vii) Statutory rights and obligation of the *"Revision Commissions"* members to attend the board (or upper board) meetings, or

(viii) Legal liability (fiduciary duties) of the members of the *"Revision Commissions"* in case of their negligence or failure to fulfill their responsibilities.

At the same time, the possibility of **more fundamental reforms, such as making it optional for companies to choose either to maintain the *"Revision Commissions"*, or to abolish them by shifting to the board's audit committee system, should not be excluded from policy considerations.**

34. There has been a lot of discussion around the world recently in terms of the independence, effectiveness, and often enlarged roles of external auditors. Together with the Basel CG Guidance, another document of the Basel Committee, "*Internal Audit in Banks and the Supervisor's Relationship with Auditors*", would provide useful guidance in terms of the external auditors of banks. As the external auditors, especially when they are backed by expertise, professionalism and independent mind, are expected to play an important role in ensuring sound corporate governance of banks, bank boards (or upper boards) as well as banking supervisors without approval of the bank ought to have enough opportunity to freely exchange views with them. **Banking laws should provide the legal basis on which banking supervisors are entitled to hear their views. Laws should require external auditors of banks to**

**report[16] to the banking supervisors whenever they find crimes or other significant breaches of laws.**

35. Effective external audit of banks increasingly needs special expertise as the banking business becomes more complex. Some Eurasian countries face difficulties in relation to this; there are only a few professional accountants with expertise in banking and the compensation for them is often too high especially for smaller banks. **Banking supervisors, capital market authorities, other governmental bodies, if any, in charge of professional accountants, and the association of accountants should work together in fostering professional accountants with special expertise in banking.**

[16] Laws should stipulate that the external auditors of banks cannot be held liable for the reporting.

## Chapter 6; Compensation

This chapter relates to Principle 6 and its annotations of the Basel CG Guidance; "*The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.*"

36. It should be noted that an extraordinary low level of remuneration of board members is no more desirable than an extraordinary high remuneration is, although the latter tends to preoccupy much public debate. It should be particularly underlined for the bank boards in countries where there is a tradition in which board members often serve as honorary jobs or as a kind of social contribution. Banks do need the boards that can effectively perform their jobs backed by professionalism and the members should be sufficiently remunerated in accordance with the responsibilities they should fulfill. Low remuneration may unable banks to attract qualified people or tempt people to obtain financial gain wrongly. **Zero or extraordinarily low remuneration of a bank board (or upper board) is never an optimum but would rather indicate that the board may not be functioning very well. The members of the *"Revision Commissions"* should also be sufficiently remunerated.**

37. For countries where there are neither market rates nor accumulated business practices in terms of remuneration – in some Eurasian countries, for instance, board (or upper board) members have traditionally served without pay - **banking supervisors, banking industry associations or others may need to develop guidance on this.** In so doing, the Basel CG guidance (annotations to Principle 6) together with the OECD Principles (annotations to Principle VI.D.4) would serve as reference points.

38. Contrary to those of the non-executive board members (or upper board members) and the members of the "Revision Commissions", **the remuneration of executive board members and senior managers should be structured so as to partially link rewards to banks' long-term performance.** Although stock option schemes are not applicable or appropriate to banks whose shares are not listed, alternative incentive schemes typically reward executive board members and senior managers with a

predetermined number of shares or cash amounts if certain challenging performance criteria are fulfilled over various periods of time.

## Chapter 7; Transparency and disclosure of information in terms of corporate governance

This chapter relates to Principle 7 and its annotations of the Basel CG Guidance; "*The bank should be governed in a transparent manner.*"

39. The Roundtable Comparative Report recommends that "convergence with international standards and practices for accounting, audit and non-financial disclosure should continue to be a top priority, especially regarding ownership and control in Eurasian companies." (Roundtable Comparative Report, p.10) Appropriate public disclosure facilitates market discipline and sound corporate governance. The third pillar of the Basel II focuses on regulations that require accurate information disclosure and facilitate market oversight and discipline of banks. Furthermore, a recent research[17] based on the databases of more than 150 counties shows that governments who implement and enforce policies that hold bank board members responsible for the provision of reliable and timely information tend to produce better-functioning banks. **National laws/regulations/rules should require banks, whether listed or not, to comply 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*.**

40. In terms of the disclosure of information specifically related to corporate governance of banks, the Basel CG Guidance (annotations to Principle 7) lists key items that should be disclosed. **In addition to these, Eurasian banks that have the *"Revision Commissions"* should disclose information related to them such as the responsibilities, size, membership, selection process, qualifications and remunerations.**

41. Concerning compliance with disclosure requirements by listed banks, the Task Force would like to stress the importance of co-operation among banking supervisors, securities regulators and stock exchanges. Even if the primary authority for ensuring

[17] Barth, J., Caprio, G. and Levine, R. (2006), *Rethinking Bank Regulation*, Cambridge University Press, New York.

proper disclosure of banks rests with banking supervisors, securities regulators are not exempt from their responsibilities to oversee and enforce standards for accounting, audit, and non-financial disclosure. **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/penalties according to relevant laws/regulations.**

## Chapter 8; Corporate governance of state-owned/controlled commercial banks (SOCBs)

42. While a few countries in Eurasia have virtually no state-owned/controlled commercial banks (SOCBs), others have a relatively large portion of these in percentage of bank assets in their countries. Theoretically speaking, there may not be much difference in improving corporate governance of SOCBs[18] and that of private sector banks, and below are some points just for the purpose of clarification.

43. Based on best practices among its member countries, the OECD has developed guidelines in terms of corporate governance of state-owned enterprises (SOEs) including banks; *the OECD Guidelines on Corporate Governance of State-Owned Enterprises* (SOE Guidelines). The Task Force agrees to the key ideas that are reiterated in the SOE Guidelines; **the state should make the SOEs have professional and effective boards (or upper boards) that can make independent judgments, and it should fully utilise the boards in overseeing the SOEs' activities while refraining from directly intervening in the day-to-day operations of the SOEs.**

44. The state should not be a passive, indifferent owner who simply acts as a rubber stamp. **It should develop and issue (make public) an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOCBs, and how it will implement its ownership policy.** The objectives stipulated in the ownership policy may include the pursuit of profitability in the form of specific targets (e.g. the rate of return or dividend policy) but may also include trade-offs, for instance between shareholder value and public service; the state should therefore indicate its priorities in the objectives.

[18] The term SOCBs here refers to commercial banks where the state has significant control, through full, majority, or significantly minority ownership. The shareholding can either be direct or indirect through other entities. They can either be listed or non-listed, but do not include what is often called "development banks" or "policy lending banks" that primarily serve as policy tools through policy lending.

45. Once the state has set the objectives for the SOCBs, it should let SOCBs' boards exercise their responsibilities and respect their independence. The objectives 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 boards 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, and thus should take advantage of the corporate form** which is presumably one reason for separating the banks from the administration in the first place. **The boards of SOCBs should be backed by professionalism and include a sufficient number of "independent" members** 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 a controlling shareholder.

46. **The SOCBs, whether listed or not, should be subject to an annual independent external audit 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.

47. The Task Force welcomes the general trend towards privatisation of SOCBs in Eurasia and firmly supports such decisions made by national authorities. Generally speaking, privatisation can bring market discipline and thus improve corporate governance. It should be noted that, at the same time, efforts in improving corporate governance of SOCBs can be made whether there is a specific plan for privatization in the future or not. Contrary to the often prevailing understanding, it is not impossible that SOEs have better corporate governance standards than private sector companies on an average. **The state as an owner should so act that the best corporate governance practices available in a jurisdiction are adopted and implemented for the SOCBs.** By doing so, the SOCBs will function as a role model of sound corporate governance and thus may create market pressure on other banks to adopt better corporate governance.

## Chapter 9; Bank's monitoring of the corporate governance practices of their corporate borrowers

48. Regardless of countries' efforts to develop sound capital markets, banks in some Eurasian countries play a more or less dominant financial role and often wield power over borrowing companies. Discussion about this topic seems to have two aspects: (i) whether banks should actively assess and monitor the corporate governance structures and practices of their borrowing companies, and (ii) to what extent banks should seek to improve the corporate governance of borrowing companies.

49. In terms of (i) above, the Task Force suggests that banks should recognise that it is in the best interests of the banks themselves to assess and monitor, *ex-ante* and *ex-post*, the corporate governance structures and practices of their corporate borrowers. Since poor corporate governance practices on the part of borrowers have a direct impact on their overall creditworthiness, both the assessment of the corporate governance structures and practices of companies to which banks are considering to provide loans, and the monitoring of them until the loans are repaid, form an important part of proper risk management. **Banking supervisors in Eurasia should therefore encourage banks to assess and monitor the quality of the corporate governance 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.

50. In terms of (ii) in paragraph 48, the extent to which banks should try to influence the practices of their corporate borrowers needs careful consideration. It would never be

an optimal economic policy to encourage banks to acquire controlling powers[19] over industries.

(i) Enhancing banks' monitoring function mentioned above should not end up with banks' arbitrary refusal to continue to provide finance to otherwise sound and solvent companies. **It can 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 in turn reduce the burden of monitoring by the bank.

(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.**

[19] For instance, in some countries in other part of the world, as the banking industry grows, banks often begin to make/allow their (ex-) employees to serve as board members or senior managers of corporate borrowers even if they do not hold any shares. Although bankers with deep knowledge of corporate finance may be able to contribute to the companies, such a business practice should nevertheless be discouraged because of the potential conflicts of interest.

## Chapter 10; The role of supervisors and the next steps

This chapter relates to section IV of the Basel CG Guidance (The role of supervisors).

51. The Base CG Guidance sets forth six principles that can assist banking supervisors in assessing corporate governance of banks and the Task Force considers that these principles include important suggestions which are applicable to the Eurasian region. Followings are further considerations based on these principles.

52. Although the Task force believes more effective and fair banking supervision is increasingly needed in the region, banking supervision, especially the direct regulations by which the banking supervisors try to prevent and correct the wrongdoings of banks, is by no means a panacea. It is impossible for banking supervisors, whose human/financial resource is not infinite, to check every action of banks in a country. **Banking supervisors should therefore put more emphasis on promoting good corporate governance practice in which banks, under the guidance and oversight by the boards (or upper boards), would naturally implement sound banking.** Banking supervisors should determine whether the bank has adopted and indeed effectively implemented sound corporate governance policies. They should also assess the quality of banks' internal control functions, internal audit and external audit.

53. The Basel CG Guidance in its section IV makes it clear that banking supervisors should provide guidance to banks on sound corporate governance and pro-active practices that should be in place. It is true that some essential elements of corporate governance should be mandated and enforced in the form of laws or regulations but others - more advanced standards which are advisable to be met but are nevertheless unable to be mandated - should be set in other forms. It is therefore useful to develop a voluntary code of national corporate governance for banks. 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 Eurasia, 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.