

Enhancing Corporate Governance for Banking Organisations

Basel Committee on Banking Supervision

Basel
September 1999

Risk Management Group of the Basel Committee on Banking Supervision

Chairman

Mr Roger Cole – Federal Reserve Board, Washington, D.C.

Banque Nationale de Belgique, Brussels	Mr Philip Lefèvre
Commission Bancaire et Financière, Brussels	Mr Jos Meuleman
Office of the Superintendent of Financial Institutions, Ottawa	Ms Aina Liepins Mr Leshak Tymcio
Commission Bancaire, Paris	Mr Frédéric Visnovsky
Deutsche Bundesbank, Frankfurt am Main	Ms Magdalene Heid
Bundesaufsichtsamt für das Kreditwesen, Berlin	Mr Uwe Neumann
Banca d'Italia, Rome	Mr Paolo Pasca
Bank of Japan, Tokyo	Mr Toshihiko Mori
Financial Supervisory Agency, Tokyo	Mr Kiyotaka Sasaki
Commission de Surveillance du Secteur Financier, Luxembourg	Mr Erik Osch
De Nederlandsche Bank, Amsterdam	Mr Job Swank
Finansinspektionen, Stockholm	Mr Jan Hedquist
Sveriges Riksbank, Stockholm	Mr Johan Molin
Eidgenössische Bankenkommision, Bern	Ms Renate Lischer Mr Martin Sprenger
Financial Services Authority, London	Ms Vyvian Bronk Mr Jeremy Quick
Bank of England, London	Ms Alison Emblow
Federal Deposit Insurance Corporation, Washington, D.C.	Mr Mark Schmidt
Office of the Comptroller of the Currency, Washington, D.C.	Mr David Gibbons
European Commission, Brussels	Ms Katharine Seal
Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements	Ms Betsy Roberts

Table of Contents

I.	INTRODUCTION	1
II.	BANK CORPORATE GOVERNANCE	3
III.	SOUND CORPORATE GOVERNANCE PRACTICES.....	5
	Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation.	5
	Setting and enforcing clear lines of responsibility and accountability throughout the organisation.	5
	Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.	6
	Ensuring that there is appropriate oversight by senior management.	7
	Effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide.	7
	Ensuring that compensation approaches are consistent with the bank’s ethical values, objectives, strategy and control environment.	8
	Conducting corporate governance in a transparent manner	8
IV.	ENSURING AN ENVIRONMENT SUPPORTIVE OF SOUND CORPORATE GOVERNANCE	10
V.	THE ROLE OF SUPERVISORS	11

Enhancing Corporate Governance for Banking Organisations

I. Introduction

1. There has been a great deal of attention given recently to the issue of corporate governance in various national and international fora. In particular, the OECD has issued a set of corporate governance standards and guidelines to help governments “in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.”¹

2. As part of its on-going efforts to address supervisory issues, the Basel Committee on Banking Supervision² has been active in drawing from the collective supervisory experience of its members and other supervisors in issuing supervisory guidance to foster safe and sound banking practices. The Committee is publishing this paper to reinforce the importance for banks of the OECD principles, to draw attention to corporate governance issues addressed in previous Committee papers, and to present some new topics related to corporate governance for banks and their supervisors to consider.

3. Banking supervision cannot function as well if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organisation. Supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank. Put plainly, sound corporate governance makes the work of supervisors infinitely easier. Sound corporate governance can contribute to a collaborative working relationship between bank management and bank supervisors.

4. Recent sound practice papers issued by the Basel Committee underscore the need for banks to set strategies for their operations and establish accountability for executing these strategies. In addition, transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a bank.

5. This guidance refers to a management structure composed of a board of directors and senior management. The Committee recognises that there are significant differences in the legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has

¹ See “OECD Principles of Corporate Governance” issued June 21, 1999.

² The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of board of directors and senior management are used in this paper not to identify legal constructs but rather to label two decision-making functions within a bank. These approaches to boards of directors and senior management are sometimes referred to as corporate governance “structures” in this paper.

6. The Basel Committee is issuing this paper to supervisory authorities worldwide in the belief that it will assist supervisors in promoting the adoption of sound corporate governance practices by banking organisations in their countries. Recognising that different structural approaches to corporate governance exist across countries, this paper encourages practices which can strengthen corporate governance under diverse structures.

II. Bank corporate governance

7. The OECD paper defines corporate governance as involving “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.”

8. Banks are a critical component of any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access to government safety nets. It is of crucial importance therefore that banks have strong corporate governance.

9. From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, affecting how banks:

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business;
- consider the interests of recognised stakeholders³;
- align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- protect the interests of depositors.

10. The Basel Committee has recently issued several papers on specific topics, where the importance of corporate governance is emphasised. These include *Principles for the management of interest rate risk* (September 1997), *Framework for internal control systems in banking organisations* (September 1998), *Enhancing bank transparency* (September 1998), and *Principles for the management of credit risk* (issued as a consultative document in July 1999). These papers have highlighted the fact that strategies and techniques that are basic to sound corporate governance include:

³ “Stakeholders” include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders.

- the corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them;
- a well-articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured;
- the clear assignment of responsibilities and decision-making authorities, incorporating a hierarchy of required approvals from individuals to the board of directors;
- establishment of a mechanism for the interaction and cooperation among the board of directors, senior management and the auditors;
- strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances;
- special monitoring of risk exposures where conflicts of interest are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the firm (e.g. traders);
- the financial and managerial incentives to act in an appropriate manner offered to senior management, business line management and employees in the form of compensation, promotion and other recognition; and
- appropriate information flows internally and to the public.

11. The reality that various corporate governance structures exist in different countries reflects that there are no universally correct answers to structural issues and that laws need not be consistent from country to country. Acknowledging this, sound governance can be practised regardless of the form used by a banking organisation. There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure the appropriate checks and balances: (1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management and audit functions. In addition, it is important that key personnel are fit and proper for their jobs. Government ownership of a bank has the potential to alter the strategies and objectives of the bank as well as the internal structure of governance. Consequently, the general principles of sound corporate governance are also beneficial to government-owned banks.

III. Sound corporate governance practices

12. As mentioned above, supervisors have a keen interest in determining that banks have sound corporate governance. The following discussion draws on supervisory experience with corporate governance problems at banking organisations and suggests the types of practices that could help to avoid such problems. These practices should be viewed as critical elements of any corporate governance process.

Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation.

13. It is difficult to conduct the activities of an organisation when there are no strategic objectives or guiding corporate values. Therefore, the board should establish the strategies that will direct the ongoing activities of the bank. It should also take the lead in establishing the “tone at the top” and approving corporate values for itself, senior management and other employees. The values should recognise the critical importance of having timely and frank discussions of problems. In particular, it is important that the values prohibit corruption and bribery in corporate activities, both in internal dealings and external transactions.

14. The board of directors should ensure that senior management implements policies that prohibit (or strictly limit) activities and relationships that diminish the quality of corporate governance, such as:

- conflicts of interest;
- lending to officers and employees and other forms of self-dealing (e.g., internal lending should be limited to lending consistent with market terms and to certain types of loans, and reports of insider lending should be provided to the board, and be subject to review by internal and external auditors); and
- providing preferential treatment to related parties and other favoured entities (e.g., lending on highly favourable terms, covering trading losses, waiving commissions).

Processes should be established that allow the board to monitor compliance with these policies and ensure that deviations are reported to an appropriate level of management.

Setting and enforcing clear lines of responsibility and accountability throughout the organisation.

15. Effective boards of directors clearly define the authorities and key responsibilities for themselves, as well as senior management. They also recognise that unspecified lines of accountability or confusing, multiple lines of responsibility may exacerbate a problem through slow or diluted responses. Senior management is responsible for creating an accountability hierarchy for the staff, but must be cognisant of the fact that they are ultimately responsible to the board for the performance of the bank.

Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.

16. The board of directors is ultimately responsible for the operations and financial soundness of the bank. The board of directors must receive on a timely basis sufficient information to judge the performance of management. An effective number of board members should be capable of exercising judgement, independent of the views of management, large shareholders or governments. Including on the board qualified directors that are not members of the bank's management, or having a supervisory board or board of auditors separate from a management board, can enhance independence and objectivity. Moreover, such members can bring new perspectives from other businesses that may improve the strategic direction given to management, such as insight into local conditions. Qualified external directors can also become significant sources of management expertise in times of corporate stress. The board of directors should periodically assess its own performance, determine where weaknesses exist and, where possible, take appropriate corrective actions.

17. Boards of directors add strength to the corporate governance of a bank when they:

- understand their oversight role and their “duty of loyalty” to the bank and its shareholders;
- serve as a “checks and balances” function vis-à-vis the day-to-day management of the bank;
- feel empowered to question management and are comfortable insisting upon straightforward explanations from management;
- recommend sound practices gleaned from other situations;
- provide dispassionate advice;
- are not overextended;
- avoid conflicts of interest in their activities with, and commitments to, other organisations;
- meet regularly with senior management and internal audit to establish and approve policies, establish communication lines and monitor progress toward corporate objectives;
- absent themselves from decisions when they are incapable of providing objective advice;
- do not participate in day-to-day management of the bank.

18. In a number of countries, bank boards have found it beneficial to establish certain specialised committees including:

- a *Risk management committee* - providing oversight of the senior management's activities in managing credit, market, liquidity, operational, legal and other risks of

the bank. (This role should include receiving from senior management periodic information on risk exposures and risk management activities).

- an *Audit committee* - providing oversight of the bank's internal and external auditors, approving their appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and 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. The independence of this committee can be enhanced when it is comprised of external board members that have banking or financial expertise.
- a *Compensation committee* – providing oversight of remuneration of senior management and other key personnel and ensuring that compensation is consistent with the bank's culture, objectives, strategy and control environment.
- a *Nominations committee* – providing important assessment of board effectiveness and directing the process of renewing and replacing board members.

Ensuring that there is appropriate oversight by senior management.

19. Senior management is a key component of corporate governance. While the board of directors provides checks and balances to senior managers, similarly, senior managers should assume that oversight role with respect to line managers in specific business areas and activities. Even in very small banks, key management decisions should be made by more than one person (“four eyes principle”). Management situations to be avoided include:

- senior managers who are overly involved in business line decision-making;
- senior managers who are assigned an area to manage without the necessary prerequisite skills or knowledge;
- senior managers who are unwilling to exercise control over successful, key employees (such as traders) for fear of losing them.

20. Senior management consists of a core group of officers responsible for the bank. This group should include such individuals as the chief financial officer, division heads and the chief auditor. These individuals must have the necessary skills to manage the business under their supervision as well as have appropriate control over the key individuals in these areas.

Effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide.

21. The role of auditors is vital to the corporate governance process. The effectiveness of the board and senior management can be enhanced by: (1) recognising the importance of the audit process and communicating this importance throughout the bank; (2) taking measures that enhance the independence and stature of auditors; (3) utilising, in a timely and effective manner, the findings of auditors; (4) ensuring the independence of the head auditor through his reporting to the board or the board's audit committee; (5) engaging external auditors to

judge the effectiveness of internal controls; and (6) requiring timely correction by management of problems identified by auditors.

22. The board should recognise and acknowledge that the internal and external auditors are their critically important agents. In particular, the board should utilise the work of the auditors as an independent check on the information received from management on the operations and performance of the bank.

Ensuring that compensation approaches are consistent with the bank’s ethical values, objectives, strategy and control environment.

23. Failure to link incentive compensations to the business strategy can cause or encourage managers to book business based upon volume and/or short-term profitability to the bank with little regard to short or long-term risk consequences. This can be seen particularly with traders and loan officers, but can also adversely affect the performance of other support staff.

24. The board of directors should approve the compensation of members of senior management and other key personnel and ensure that such compensation is consistent with the bank’s culture, objectives, strategy and control environment. This will help to ensure that senior managers and other key personnel will be motivated to act in the best interests of the bank.

25. In order to avoid incentives being created for excessive risk-taking, the salary scales should be set, within the scope of general business policy, in such a way that they do not overly depend on short-term performance, such as short-term trading gains.

Conducting corporate governance in a transparent manner

26. As set out in the Basel Committee’s paper *Enhancing bank transparency*, it is difficult to hold the board of directors and senior management properly accountable for their actions and performance when there is a lack of transparency. This happens in situations where the stakeholders, market participants and general public do not receive sufficient information on the structure and objectives of the bank with which to judge the effectiveness of the board and senior management in governing the bank.

27. Transparency can reinforce sound corporate governance. Therefore, public disclosure is desirable in the following areas:

- Board structure (size, membership, qualifications and committees);
- Senior management structure (responsibilities, reporting lines, qualifications and experience);
- Basic organisational structure (line of business structure, legal entity structure);

- Information about the incentive structure of the bank (remuneration policies, executive compensation, bonuses, stock options);
- Nature and extent of transactions with affiliates and related parties.⁴

⁴ For example, the International Accounting Standards Committee defines related parties as "those able to control or exercise significant influence. Such relationships include: (1) parent-subsidiary relationships; (2) entities under common control; (3) associates; (4) individuals who, through ownership, have significant influence over the enterprise and close members of their families; and (5) key management personnel". The IASC expects that disclosures in this area should include. (a) the nature of relationships where control exists, even if there were no transactions between the related parties; and (b) the nature and amount of transactions with related parties, grouped as appropriate. (IASC International Accounting Standard No. 24, *Related Party Disclosures*).

IV. Ensuring an environment supportive of sound corporate governance

28. The Basel Committee recognises that primary responsibility for good corporate governance rests with boards of directors and senior management of banks; however, there are many other ways that corporate governance can be promoted, including by:

- governments – through laws;
- securities regulators, stock exchanges – through disclosure and listing requirements;
- auditors – through audit standards on communications to boards of directors, senior management and supervisors; and
- banking industry associations – through initiatives related to voluntary industry principles and agreement on and publication of sound practices.

For example, corporate governance can be improved by addressing a number of legal issues, such as the protection of shareholder rights; the enforceability of contracts, including those with service providers; clarifying governance roles; ensuring that corporations function in an environment that is free from corruption and bribery; and laws/regulations (and other measures) aligning the interests of managers, employees and shareholders. All of these can help promote healthy business and legal environments that support sound corporate governance and related supervisory initiatives.

V. The Role of Supervisors

29. Supervisors should be aware of the importance of corporate governance and its impact on corporate performance. They should expect banks to implement organisational structures that include the appropriate checks and balances. Regulatory safeguards must emphasise accountability and transparency. Supervisors should determine that the boards and senior management of individual institutions have in place processes that ensure they are fulfilling all of their duties and responsibilities.

30. A bank's board of directors and senior management are ultimately responsible for the performance of the bank. As such, supervisors typically check to ensure that a bank is being properly governed and bring to management's attention any problems that they detect through their supervisory efforts. When the bank takes risks that it cannot measure or control, supervisors must hold the board of directors accountable and require that corrective measures be taken in a timely manner. Supervisors should be attentive to any warning signs of deterioration in the management of the bank's activities. They should consider issuing guidance to banks on sound corporate governance and the pro-active practices that need to be in place. They should also take account of corporate governance issues in issuing guidance on other topics.

31. Sound corporate governance considers the interests of all stakeholders, including depositors, whose interests may not always be recognised. Therefore, it is necessary for supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors.