

**British Bankers' Association response to the Basel Committee on Banking
Supervision's Consultative document on Guidelines for Corporate governance
principles for banks**

January 2015

Introduction

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

We have the largest and most comprehensive policy resources for banks in the UK and represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

We are pleased to respond to the Basel Committee Banking Supervision's revised guidelines on corporate governance principles for banks¹ of which we are very supportive. If trust and confidence in banks and bankers is to be restored leaders of financial institutions must take collective and personal responsibility for ensuring that the right culture is evident and active at all levels within their bank. These revised principles will contribute to ensuring that this is the case.

As well as making a few general comments we have highlighted below the few areas where we recommend that the Principles to be changed although emphasise that we are in strong agreement with both the thrust and content of the proposed guidelines.

Proportionality

Although we are pleased to see the concept of proportionality being emphasised at the beginning of the proposed guidelines in paragraph 13, this is the only reference to this throughout the Consultative Document that we can find. It is important to emphasise that the principle of proportionality must be applied in practice so that the corporate governance framework is workable for smaller banking institutions as well as for internationally active banking groups. On the one hand the principles based approach, which we very much support, facilitates this but conversely without more continuous reference to this important concept it may get overlooked as the Basel principles are translated into national requirements.

¹ <http://www.bis.org/publ/bcbs294.pdf>

Application to subsidiaries

The corporate governance principles set out in the Consultative Document should be applied on a bank group level and on a subsidiary level only where that subsidiary is significant, based on the bank's own assessment agreed with its college, recognising the principle of proportionality.

It would be helpful if the final version of the Basel Committee's Principles would recognise that banking groups should have the possibility to call upon their supervisory college to discuss - and, if possible, resolve - ambiguities which may exist concerning the scope of application of national requirements.

The role of the Board as distinct from senior management

Our vision of the board is of a group of executive and non-executive directors (the latter being in the majority) who bear a joint responsibility for overseeing the activities and governance of the bank. The board should not be responsible for the active management of its day-to-day business operations, which remain the domain of senior executive management, but should scrutinise senior executive management and be collectively accountable to stakeholders for reporting of the bank's performance.

We welcome that our vision is reflected in the overall tone of the consultation paper but there are a few paragraphs within the Principles which appear to suggest more active involvement by the board in the management of the bank, which we do not support. In particular the term 'establish' is used more frequently than we would recommend, implying as it does that the board should take a role in developing and implementing policies, procedures and strategies, rather than overseeing and challenging, once senior management has established them.

Recommendations

Principle 1: Board's overall responsibilities

We agree with the activities that the Board should undertake, as articulated in paragraph 23, but would re-orientate its responsibilities to a more explicitly oversight role with a focus on how it, the board, rather than the wider bank operates.

As we note above we are concerned at the implied level of board involvement in operational business activities. Paragraph 40, for example, suggests that the board approve compliance policies; however, with ever increasing demands being made of company boards it is crucial that they make the best use of their time. In this instance, their time would be better spent in setting the governance principles of the group and agreeing the risk management and internal control framework (which informs compliance policies) with oversight of the executive management team.

We also think it is important that the board is responsible for ensuring a robust whistleblowing policy. We therefore recommend re-wording paragraph 23 as follows:

23. Accordingly, the board should **require that sound risk management and control systems are in place that enable it to effectively:**

- ~~establish and~~ monitor the bank's business objectives and strategy;

- ~~establish~~ **test** the bank's corporate culture and values;
- oversee implementation of the appropriate governance framework;
- **oversee the development**, along with senior management and the CRO, ~~of~~ the bank's risk appetite, taking into account the competitive and regulatory landscape, long-term interests, exposure to risks and the ability to manage **or mitigate** risk effectively;
- monitor the bank's adherence to the RAS, risk policy and risk limits;
- approve and oversee the **approach to** ~~implementation of~~ the bank's capital adequacy assessment process, capital and liquidity plans, compliance policies and obligations, and the internal control system;
- approve the selection, ~~and~~ oversee the performance of and, **if necessary, the dismissal of executive and non-executive directors** ~~senior management~~; and
- oversee the design and **approach to** ~~operation of~~ the bank's compensation system, and monitor and review the system to ensure that it is aligned **by seeking where necessary objective assurance that the bank's desired risk culture and risk appetite are properly reflected in decisions, actions and behaviours throughout the firm:**
 - **assessing the integrity, independence and effectiveness of the bank's policies and procedures for whistleblowing and protecting staff who raise concerns from detrimental treatment.**

Consistent with our opening comments that the board should not be responsible for the active management of its day-to-day business operations, we would recommend following amendments to reflect these concerns:

24. The board should ~~ensure that~~ **assess** whether transactions with related parties (including internal group transactions) are reviewed to assess risk and are subject to appropriate restrictions (eg by requiring that such transactions be conducted on arm's length terms) and that corporate or business resources of the bank are not misappropriated or misapplied.
28. In order to promote a sound corporate culture, the board should ~~take the lead in establishing~~ **reinforce** the "tone at the top" by:
 - setting and adhering to corporate values for itself, senior management and other employees that create expectations that all business should be conducted in a legal and ethical manner;
 - promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that all employees are responsible for **helping** ~~ensure that~~ the bank operates within the agreed risk appetite and risk limits;
 - ~~ensuring~~ **reviewing** whether appropriate steps are taken by management to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies; and

~~ensuring~~ **assessing** whether employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions

The role of the independent audit function is important so we recommend some minor changes to paragraph 41, as follows:

41. The third line of defence consists of an ~~independent and~~ effective internal audit function **independent of senior management**. Among other things, it provides independent, **objective** review and assurance on the quality and effectiveness of the bank's risk governance framework including links

to organisational culture, as well as strategic and business planning, compensation and decision-making processes. Internal auditors must be competent and appropriately trained and not involved in developing, implementing or operating the risk management function (see Principle 9).

We feel that the proposals in Paragraph 43 may undermine the Chief Executive's ability to select and appoint his senior executive team. Rather than suggesting that the board may select certain senior management and the heads of control functions, we would recommend that the Chief Executive always retains this right but that the board might be consulted on preferred candidates. We therefore recommend an amendment as follows:

43. The board should select the CEO and may ~~select~~ **review the appointment of** other key members of senior management, as well as the heads of the control functions **and ensure that there is an appropriate succession planning process.**

Principle 2: Board qualifications and composition

We believe that a key aspect of effective board is its independence and that to ensure this at least half the board should be independent non-executive directors.

We therefore recommend the amendment of paragraph 45 as follows:

45. The board must be ~~suited~~ able to carry out its responsibilities and have a composition that facilitates effective oversight. For that purpose, **at least half of** the board should be comprised of a ~~sufficient number~~ of independent **non-executive** directors **whom should have a means to employ experts outside of the Board as needed.**

We note that independence of mind is of greater importance in the case of non-executive directors and would therefore recommend that paragraph 49 be amended as follows:

49. The selection process should include reviewing whether board candidates: (i) possess the knowledge, skills, experience and, **particularly in the case of non-executive directors,** independence of mind given their responsibilities on the board and in the light of the bank's business and risk profile; (ii) have a record of integrity and good repute; and (iii) have sufficient time to fully carry out their responsibilities.

Principle 3: Board's own structure and practices

We note the recommendation in paragraph 60 that the board chairman should not serve as chair of any board committee. We would question this proposal. For example, in our view, the board chairman should chair the Nomination Committee given the chairman is ultimately accountable for the composition and performance of the board. In addition, there may be other ad hoc board committees established from time to time which it is appropriate for the board chairman to chair. We would suggest that this recommendation is revised to make clear that the board chairman may serve as chair of other committees as appropriate.

We therefore recommend the deletion of paragraph 60.

We would be grateful for clarification on the intention behind the reference in section 68 to “third party opinions” with regard to the design and effectiveness of the risk and internal control framework. We assume this does not go as far as requiring the engagement of external advisors to opine on internal governance matters? We would question the appropriateness and cost implications of such a requirement.

We note the requirement in paragraph 70, that the audit committee be comprised entirely of independent directors whereas the risk committee need only have a majority of independent directors. It would be helpful to understand the reasons for this difference. Our preference is that both board committees should have the same composition requirements and that best practice would suggest all should be independent directors.

We also note that there is a significant disparity in the level of detail in the descriptions of the composition, roles and responsibilities of the audit committee and other board committees. We note that the proposals relating to the compensation committee, in particular, are at a high level. Again, it would be helpful to understand the reasons for these differences.

With regards to holding cross-committee meetings, as proposed in paragraph 74, although we agree that there is a need for engagement and a flow of information between board committees, we are unsure of the value of joint meetings where there is typically cross-membership of board committees and the chairs of committees generally report back to the board after each committee meeting.

We believe it is common practice for the audit committee to take responsibility of the bank’s whistle blowing policy so recommend that it be explicitly tasked to do so by adding a further bullet point to paragraph 68, as follows:

68. The audit committee is responsible, among other things, for:

...
...

- **overseeing that the bank has effective whistle-blowing processes and procedures.**

We agree that is important to manage conflicts of interests to which a board member may be subject but would suggest widening this requirement to include members of the board members immediate family, as follows in paragraph 82:

- a member’s responsibility to abstain from voting on any matter where the member, **or any member of her or his immediate family,** may have a conflict of interest or where the member’s objectivity or ability to properly fulfil duties to the bank may be otherwise compromised;

Principle 4: Senior management

Whistleblowing is an important mechanism for identifying poor practices and preventing wrong-doing in banks, so we recommend that this be explicitly identified in paragraph 93, as follows:

- internal control failures; and
- legal or regulatory concerns

▪ **matters raised as a result of the bank's whistleblowing procedures**

Principle 5: Governance of group structures

We note that the group structure should be subject to a periodic independent formal review. We assume this does not go as far as to require the engagement of external advisors to opine on internal governance matters? We would question the appropriateness and cost implications of such a requirement.

Principle 6: Risk management

The key activities of the risk management function listed in paragraph 103 are dependent on there being adequate systems and controls in place to monitor the principal risks to which the bank is exposed.

We therefore suggest that the start of this list should require the CRO to ensure such systems are in place, as follows:

- ensuring that the bank has sound risk management and internal control systems in place

Principle 7: Risk identification, monitoring and controlling

We note that paragraph 120 pragmatically permits the bank to temporarily exceed pre-agreed risk limits. We consider that mechanisms should be in place to require material excesses to be reported to the board and that this paragraph could be helpfully amended to reflect this:

when there is a decision to accept or take risk that is beyond risk limits (i.e. on a temporary basis) or take risk that cannot be hedged or mitigated, the risk management function should report **material exemptions to the board and** monitor the positions to ensure that they remain within the bank's framework of limits and controls or within exception approval.

In the excitement of new product creation insufficient attention is paid to how risk to the institution could change over the product's life, including for instance its deployment in 'off-label' circumstances for which it was not originally designed. This could be reflected by an amendment to the first bullet point of paragraph 121:

- A full ~~and frank~~ assessment of risks **over the product life-cycle** under a variety of scenarios, as well as an assessment of potential shortcomings in the ability of the bank's risk management and internal controls to effectively manage associated risks.

Principle 8: Risk communication

We have no substantive comments of this principle but question, in paragraph 129, the first sentence, not understanding the link between 'risk reporting systems' and 'underlying assumptions'. We therefore suggest that this sentence be truncated as follows:

129. Risk reporting systems should be dynamic, comprehensive and accurate, ~~and should draw on a range of underlying assumptions.~~

Could this clause be better moved to the end of the last second sentence of paragraph 128, which is designed to provoke discussion about, among other things, stress testing where for that discussion to be comprehensive an appreciation of any underlying assumptions is needed.

128. Risk reporting to the board requires careful design in order to ensure that bank-wide, individual portfolio and other risks are conveyed in a concise and meaningful manner. Reporting should accurately communicate risk exposures and results of stress tests or scenario analyses and should provoke a robust discussion of, for example, the bank's current and prospective exposures (particularly under stressed scenarios), risk/return relationships and risk appetite and limits, **drawing on a range of underlying assumptions**.

Principle 9: Compliance

We have no comments on this Principle, agreeing with it fully.

Principle 10: Internal audit

We agree that internal audit, as the third line of defence, is a key provider of independent assurance and have some recommendations to ensure that this function is able to provide robust and independent challenge to the business line and oversight functions such as compliance.

142. The board and senior management can enhance the effectiveness of the internal audit function by:

- **ensuring that the scope of the internal audit functions activities is unrestricted:**
 - requiring the function to independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes;
 - **requiring timely and effective correction of audit issues by senior management**
 - requiring internal auditors to adhere to national and international professional standards, such as those established by the Institute of Internal Auditors; and
 - ensuring that audit staff have skills and resources commensurate with the business activities and risks of the bank.
- **Ensuring the internal audit function has an internal quality assurance capability and that its performance is regularly assessed against appropriate criteria and is subject to an independent external assessment at least every five years.**
- **Requiring a periodic assessment of the firm's overall risk governance framework, involving an assessment of:**
 - **The effectiveness of the risk management and compliance functions**
 - **The quality of risk reporting to the board and senior management**
 - **The effectiveness of the firm's internal policies and systems and controls**

143. The board and senior management should respect and promote the independence of the internal audit function by, for example:

- **ensuring that that primary reporting line of the chief internal audit executive is to the board or its audit committee, including his or her selection, performance oversight and, if necessary, dismissal;**

- **giving internal audit the right to observe executive committee meetings and have timely and unfettered access to management information and committee materials;**
- ensuring that internal audit reports are provided to the board without management filtering and that the internal auditors have direct access to the board or the board's audit committee;
- ~~requiring timely and effective correction of audit issues by senior management.~~
- ~~requiring a periodic assessment of the bank's overall risk governance framework including, but not limited to, an assessment of:~~
 - ~~○ the effectiveness of the risk management and compliance functions;~~
 - ~~○ the quality of risk reporting to the board and senior management; and~~
 - ~~○ the effectiveness of the bank's system of internal controls.~~

Principle 11: Compensation

The updates made to the board's role with regards to the company's compensation practices bring these into line with the recently published guidance by the European Banking Authority. We welcome the fact that policy makers have taken a consistent approach. We note however that the proposal in section 146 that the board should be responsible for reviewing and setting the remuneration of senior executives may potentially confuse the relative responsibilities of the board and the compensation committee. In addition, there is a contradiction (in section 109) in the case of the compensation of the CRO, which appears to remove the compensation committee from this process and envisages instead a role for the risk committee. We would suggest that care is taken to ensure that the responsibilities of the compensation committee (as described in principles 75 and 147) are not compromised.

Principle 12: Disclosure and transparency

We have no comments on this principle.

Principle 13: The role of supervisors

As we noted above it would be helpful if the college of supervisors mechanism could be used to resolve differences in the interpretation of corporate governance requirements which may differ between jurisdictions.

We therefore suggest amending the third sentence of paragraph 169, as follows;

....sharing is particularly important between home and host supervisors of cross-border banking entities.³² Cooperation can occur on a bilateral basis, in the form of a supervisory college or through periodic meetings among supervisors at which corporate governance matters should be discussed **and differences of interpretation resolved**. Such communication

We would be delighted to discuss our propose changes with the Basel Committee if appropriate.

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