

January 9, 2015

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs/Mesdames:

Re: Corporate Governance Principles for Banks

The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

The CBA appreciates the opportunity to comment on the following consultative document issued by the Basel Committee on Banking Supervision in October 2014: *Corporate governance principles for banks* (the **Consultative Document**).

Guiding Principle

As noted in the press release accompanying the Consultative Document, the principles in the document are intended to update the *Principles for Enhancing Corporate Governance* that were issued by the Basel Committee in October 2010. As the Consultative Document notes, since 2010, banks globally have made progress in various areas of corporate governance and national regulatory authorities have taken measures to improve regulatory and supervisory oversight of corporate and risk governance at banks. We understand that the updated expectations in the Consultative Document are intended to take into account the peer review recommendations made by the Financial Stability Board and other recent papers addressing corporate governance issues.

It is our view that the fundamental guiding principle that should be used by the Basel Committee in applying the Consultative Document is one of tailoring the approach to the particular circumstances. Guidance issued by the Basel Committee applies to banks in member jurisdictions around the world. Within each jurisdiction, there is a range of banks that vary widely in asset size, complexity of structure and activities and risk profile. Member jurisdictions themselves vary widely in terms of the legislative and regulatory requirements that are in place, as well as the policy environments in which financial regulation is shaped. For these reasons, we are pleased to see that the Consultative Document notes the significance of jurisdictional differences, as well as the importance of considering proportionality when implementing the principles set out in the Consultative Document. We suggest that the Committee's view in this respect be further confirmed and emphasized in the final Consultative Document.

Board's Supervisory Role

We are concerned that the implementation of the principles set out in the Consultative Document could result in a significant increase in the responsibilities of a bank's board of directors (**Board**) such that the directors' ability to carry out their responsibilities could be compromised. Further, we are concerned that, in some instances, the language in the Consultative Document appears to blur the roles of the Board and senior management.

We agree with the Committee's guidance that the Board has "the ultimate responsibility for the bank's business strategy and financial soundness, key personnel decisions, internal organization and governance structure and practices, and risk management and compliance decisions". That said, placing the responsibility on the Board as a whole to be proactively involved in matters relating to the day-to-day operations of the bank might not be tenable in practice. In particular, we have concerns about the following responsibilities being placed on the Board.

The Consultative Document states that the Board should implement and monitor the bank's adherence to the risk appetite statement, risk policy and risk limits. It is difficult to see how a Board could implement and proactively monitor the bank's risk management functions, especially since the term "implement" suggests specific steps need to be undertaken by the Board and "monitor" implies this action would have to be taken on an ongoing basis. We believe it would be preferable for the Consultative Document to expressly indicate that the Board will carry out its oversight and supervisory role in respect of the bank's risk management functions, in reliance on assurances from committees of the Board and/or senior management with effective challenge, as appropriate. The Consultative Document also states that the Board should oversee the operation of the bank's compensation system. The reference to the "operation" of the compensation system suggests that the Board's oversight responsibility should be exercised on an ongoing basis. Here again, we recommend that the Board be permitted to rely on the assurances of board committees and/or senior management rather than directing Boards to be

directly involved in the operation of a compensation system.

Board's Own Structure and Practices

The seventh bullet under paragraph 68 of Principle 3 states that the audit committee is responsible for reviewing the third-party opinions on the design and effectiveness of the overall risk governance framework and internal control system. We suggest revising this bullet to state that the audit committee is responsible for reviewing the third-party opinions, as may be executed, on the design and effectiveness of internal control system components. We believe the review of the design and effectiveness of the overall risk governance framework is a more appropriate responsibility for the risk committee.

Governance of Group Structures

We have set out in Appendix A to this letter some suggested edits to the language in Principle 5: Governance of group structures.

We support the notion that the Board has responsibility for ensuring that there is a clear governance framework in place, including approving the framework where appropriate. We note, however, that it should not be the responsibility of the Board to create the framework itself. This is reflected in the suggested amendment to Paragraph 95.

Furthermore, we suggest that the reference to the independent legal and governance responsibilities that apply to subsidiary boards in Paragraph 95 be reiterated at the beginning of Paragraph 96. This is to ensure that the legal responsibilities of the subsidiary directors are given primary consideration by group management when carrying out their responsibilities bulleted in Paragraph 96.

We suggest that it be made clear in the first bullet of Paragraph 96 that roles and responsibilities will vary with the complexity of each subsidiary. For example, a more complicated subsidiary may have its own audit and conduct review committee ("ACRC"), whereas a less complex subsidiary may use the parent company's ACRC and a pure holding company may not require an ACRC at all.

The fourth bullet under paragraph 95 of Principle 5 notes that the group's corporate governance framework should include appropriate processes and controls to identify and address potential intragroup conflicts of interest. In large financial conglomerates, there are likely many intra-company service agreements in place, many of which are not material. We believe that it would be appropriate to apply a materiality threshold for considering conflicts of interest. Also, to be both clear and concise, we have combined the fourth bullet with the third bullet.

We suggest that it be made clear that subsidiary boards may rely on management and operational support from the parent company and affiliates. However, such reliance does not relieve the subsidiary's directors of their legal and governance responsibilities.

Paragraph 99 references risks arising from products, services and structures. Given that this category of risk is also applicable to the parent company, we query whether it should be in the section relating to complex or opaque structures.

The first bullet in paragraph 100 states that senior management, and the Board as appropriate, should avoid setting up unnecessarily complicated structures or an "inordinate number of legal entities". What constitutes an "inordinate" number of entities for one financial conglomerate might not be same for another. We support the principle that the structure of financial conglomerates should be streamlined where possible, but do not agree that exceeding a specific number of subsidiaries gives rise to problems. Perhaps it would be more appropriate for the Consultative Document to focus on appropriate lifecycle management of subsidiaries in this section.

Paragraph 101 recommends a periodic independent formal review of the structures, their controls and activities, as well as their consistency with board-approved strategy. We respectfully submit that such review may not be necessary or efficacious provided that all the other governance measures cited in this section are implemented.

Paragraph 106 recommends that *"In banking groups, there should be a group CRO in addition to subsidiary-level risk officers."* We suggest that the appointment of subsidiary-level risk officers should be based on the complexity of the subsidiary. This would be consistent with Paragraphs 104, 122 and 123.

Risk Identification, Monitoring and Controlling

Again, with a view to fostering appropriate separation between the roles of senior management and the Board, we suggest some amendments. The first bullet of paragraph 118 states that internal stress tests should cover a range of scenarios and senior management and, as applicable, the Board should review and approve the scenarios that are used in the bank's risk analyses. We recommend revising this bullet so that the focus of the Board is on reviewing and providing effective challenge where appropriate on scenarios established by senior management, rather than the Board approving the scenarios. We also recommend revising the last sentence of paragraph 124 to state, "The risk management function should be actively involved in assessing risks that could arise from mergers and acquisitions and report its findings directly to senior management and the board or risk committee, as appropriate".

Internal Audit

The last two bullets of paragraph 143 state that the Board and senior management should respect and promote the independence of the internal audit function by (i) requiring timely and effective correction of audit issues by senior management, and (ii) requiring a periodic assessment of the bank's overall governance framework including, but not limited to, an assessment of the effectiveness of risk management and the compliance functions, the quality of risk reporting to the Board and senior management, and the effectiveness of the bank's system of internal controls. We believe these two bullets should be moved under paragraph 140 as they directly relate to the effectiveness of the internal audit function rather than the Board and senior management respecting and promoting the independence of the internal audit function.

We hope you find our comments on the Consultative Document useful. Please let us know if you have any further questions or would like to discuss our recommendations in further detail.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'N. M. K.', is written over a horizontal line.

APPENDIX A

Principle 5: Governance of group structures

In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring that ~~there is~~management has implemented a clear governance framework appropriate to the structure, business and risks of the group and its ~~entities~~¹⁷ subsidiaries.¹⁷ The board and senior management should know and understand the bank's operational structure and the risks that it poses.

Parent company boards

94. In operating within a group structure, the board of the parent company should be aware of the material risks and issues that might affect both the bank as a whole and its subsidiaries. ~~It should exercise~~Through their oversight of management, the board should ensure that management has adequate oversight over subsidiaries while respecting the independent legal and governance responsibilities that might apply to subsidiary boards.

95. In order to fulfil its responsibilities, the board of the parent company should ~~-, subject to the independent legal and governance responsibilities that apply to subsidiary boards, ensure that management:~~

- ~~establish~~establishes a group structure (~~including being~~ the legal entity structure and business structure) and a corporate governance framework with clearly defined roles and responsibilities, ~~including those~~ at the parent company level and ~~those~~ at the subsidiary level, as may be appropriate based on the complexity of the subsidiary;
- ~~define~~defines an appropriate subsidiary board composition policy and management structure to contribute to the effective oversight of businesses and subsidiaries, which takes into account the different risks to which the group, its businesses and its subsidiaries are exposed;
- ~~assess~~assesses whether the group's corporate governance framework includes adequate policies, processes and controls to identify material intragroup conflicts of interest, and addresses riskrisk management across the businessbusinesses and legal entity structures; subsidiaries;
- ~~ensure the group's corporate governance framework includes appropriate processes and controls to identify and address potential intragroup conflicts of interest, such as those arising from intragroup transactions;~~
- ~~approve~~develops policies and clear strategies for establishing new structuresubsidiaries and legal entities, dissolving subsidiaries and ensureensures that they are consistent with the policies and interests of the group;
- ~~assess~~assesses whether there are effective systems in place to facilitate the exchange of information among the various entitiesbetween subsidiaries and the parent company to manage the risks of the separate entities subsidiaries as well as of the group as a whole, and to ensure effective supervision of the group;
- ~~have~~has sufficient resources to monitor the compliance of subsidiaries with all applicable

legal, regulatory and governance requirements; and

- ~~maintain~~**maintains** an effective relationship with both the home regulator and, through the subsidiary board or direct contact, with the regulators of all subsidiaries.

17 Banks that are part of a conglomerate should also take into account the Joint Forum's *Principles for the supervision of financial conglomerates* (September 2013, www.bis.org/publ/joint29.htm); www.bis.org/publ/joint29.htm). For purposes of the corporate governance principles herein, "parent company" and "group" refer to a financial group.

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Subsidiary boards

96. While the strategic objectives, risk governance framework, corporate values and corporate governance principles of the subsidiary ~~bank~~ should align with that of the parent company (referred to here as "group policies"), the subsidiary board should make necessary adjustments where a group policy conflicts with an applicable legal or regulatory provision or prudential rule, or would be detrimental to the sound and prudent management of the subsidiary.

97. In the case of a significant regulated subsidiary (due to its risk profile or systemic importance or due to its size relative to the parent company), the board of the significant subsidiary should take such further steps as are necessary to help the subsidiary meet its independent corporate governance responsibilities and the legal and regulatory requirements that apply to it.

Complex or opaque structures

98. Banks create structures for legal, regulatory and tax purposes. Structures can take the form of units, branches, subsidiaries or other legal entities that can considerably increase the complexity of the organisation. The number of legal entities, and in particular the interconnections and intragroup transactions among such entities, can lead to challenges in identifying and managing the risks of the organisation as a whole.

99. Operating through complex or non-transparent structures may pose financial, legal, reputational and other risks to the bank. It may impede the ability of the board and senior management to conduct appropriate business oversight and could hinder effective banking supervision. In addition, the bank may also be indirectly exposed to risk when it performs certain services or establishes structures on

behalf of customers.¹⁸ Examples include acting as a company or partnership formation agent, providing a range of trustee services and developing complex structured finance transactions for customers. While these activities are often profitable and can serve the legitimate business purposes of customers, customers may in some cases use products and activities provided by banks to engage in illegal or inappropriate activities.

100. Senior management, and the board as appropriate, should be cognisant of these challenges and take appropriate action to avoid or mitigate them by:

- ~~avoiding setting up unnecessarily complicated structures of an inordinate number of legal entities.~~
- ~~continually maintaining and reviewing appropriate policies, procedures and processes governing the approval and maintenance of those structures or activities, including fully vetting the purpose, the associated risks and the bank's ability to manage those risks prior to setting up new structures and initiating associated activities.~~
- ~~having a centralised process for approving the creation of new legal entities/subsidiaries based on established criteria, including the ability to monitor and fulfil each entity's/subsidiary's regulatory, tax, financial reporting, governance and other requirements, and for the dissolution of dormant subsidiaries.~~
- ~~establishing adequate procedures and processes to identify and manage all material risks arising from these structures, including lack of management transparency, operational risks introduced by interconnected and complex funding structures, intragroup exposures, trapped~~

¹⁸ See BCBS, *Customer due diligence for banks*, October 2001, www.bis.org/publ/bcbs85.htm.

collateral and counterparty risk. The bank should only approve structures if the material risks can be properly identified, assessed and managed.

- ensure that the activities and structure are subject to regular internal and external audit reviews.

101. The board of the parent company can enhance the effectiveness of the above efforts by requiring a periodic independent formal review of the structures, their controls and activities, as well as their consistency with board-approved strategy.

102. ~~The~~Subject to applicable laws, the board should be prepared to discuss with, and as necessary report to, the bank's supervisor and the host country supervisors the policies and strategies adopted regarding the establishment and maintenance of these structures and activities.

Comment [mm1]: Query whether this reference should be to "trapped capital".