

Feedback on BCBS Consultative paper *“Principles for Enhancing Corporate Governance”*

The Institute of International Finance (IIF) welcomes the opportunity to comment on the Basel Committee (BCBS) consultative document *“Principles for Enhancing Corporate Governance”*. As noted in the IIF’s 2008 Report of the Committee on Market Best Practices, corporate governance and specifically risk governance, are priority areas on which both the industry and the regulatory community ought to focus.

We are supportive of the objectives sought with the revisions to the BCBS Corporate Governance Guidance and believe the consultative document represents an important step forward towards improvements in the area of risk governance. While there are aspects of the proposals that merit revisions, we note that the spirit of the proposed reforms is in line with revised industry practices as detailed in the Final Report of the IIF Committee on Market Best Practices (“Market Best Practices Report”)¹, published in 2008.

Below we present some general observations on the proposed guidance as well as specific suggestions on the proposed text.

1. General Comments

- The IIF supports the BCBS decision to introduce reforms to the existing corporate governance guidance. Risk governance, the roles of senior management and the Board and disclosure and transparency are clearly priority areas.²
- The Institute shares the BCBS view that the supervisory guidance should also play a role as a reference point for banks’ own corporate governance efforts. Complemented with industry’s own guidance, the BCBS document is a useful set of principles for revising firms’ governance practices and policies. Similarly, the clarification that the guidance does not establish an additional regulatory framework on top of national legislation is helpful. Supervisors, therefore, will find the guidance useful in evaluating the quality of banks’ corporate governance frameworks.
- The Institute supports the underlying principles of materiality and proportionality, which should be used whenever applying the guidance to specific firms. Clearly, not all aspects of the guidance apply in the same way to all firms (which differ in size, business mix, differing degrees of

¹ <http://www.iif.com/download.php?id=Osk8CwI08yw=>

² Compensation is also an area of priority although the issue has been dealt with thoroughly on separate FSB and BCBS guidance. The IIF 2008 CMBP Report also includes specific industry practice recommendations on this issue.

structural complexity, local legal regime and corporate culture). These are all factors that play a significant role when determining the specific way the guidance applies to an individual firm. Such principles, however, should not undermine in any way the general applicability of the principles contained in the guidance.

- Similarly, the IIF finds it extremely useful that the guidance recognizes that local corporate and tax laws affect individual firms' corporate governance policies and that both are significant factors for differences across jurisdictions. Such recognition is essential to avoid prescriptive and rigid applications of the guidance.
- In order to manage their risks more effectively, global groups of companies monitor and manage their operations on a group-wide basis rather than on a strict legal entity basis. In this respect, the Principles should permit firms to continue to adopt such an approach.
- One specific issue that derives from legal differences across jurisdictions is that of the legal meaning of the terms "management" and "boards", "Management Board" and "Executive Board". In many jurisdictions, banks have an "executive/management board" mostly composed of bank executives, which does have management functions and a "supervisory board", which plays a purely supervisory role. The roles and responsibilities of these "Boards" are legally substantially different. We believe that although the guidance does not *per se* blur these differences, it would be helpful if the final guidance takes note of the distinction.
- Finally, we note a tension throughout the document regarding the distinction between the roles of "management" and "Boards". The IIF believes that more clarity should exist as to the roles of these different entities. Legal, organizational and (not less importantly) practical considerations determine that management is more directly involved in the specific aspects of running the businesses and affairs of the banking group. The key distinction between the two roles is that of the "monitoring" and "oversight" nature of the role of the Board. The guidance, in several instances, blurs this distinction, assigning to the Board roles and functions that by law pertain more appropriately to senior management (including that of "ensuring" a number of different functions and actions). To the extent that roles and functions are clearly assigned and separated, and that the Board performs its oversight function adequately, corporate governance can be robust and adequate and achieve the goals of the firm's stakeholders.

2. Specific Comments

Below, we present specific comments on the various provisions contained in the guidance. References are made to the Principles and paragraph numbers in the consultative document:

Introduction

- "Risk appetite/tolerance" (Para 5): the IIF believes that sufficient academic and industry practice has developed in regard to the distinction between risk "appetite" and risk "tolerance". Such distinction is noted in footnote 7. Therefore, we would encourage the BCBS to use the term "risk appetite" in the guidance. Further methodological discussion of this issue can be found in

the Report of the IIF Steering Committee on Implementation “*Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*”³, published in December 2009.

Principle 1: Board Responsibilities

- Selection of executives (Para 25): in some jurisdictions, the role of “selecting” senior members of management is one that pertains to management itself (except the case of the CEO, who should be appointed by the Board). Strict interpretation of the proposed principle (assigning this role to the Board) would deprive, in these jurisdictions, the CEO from one of her/his fundamental roles - that of selecting (and replacing) senior management (including the CFO, the CRO, etc.). The guidance should be clarified to indicate that this role of the Board may refer only to the CEO function (and to his deputies if they are appointed by the Board, as is the case in some jurisdictions).
- Performance Standards (Para 26): similarly, the guidance should take into account that in some jurisdictions, the setting of performance standards for members of management other than the CEO (and Deputy CEOs appointed by the Board) is the responsibility of the CEO and not of the Board. The Board should then “approve” rather than “set” such standards.
- Lines of Responsibility (Para 27): while Boards have the clear role of defining the main lines of responsibility, it seems unrealistic in large banking groups to expect the Board to “set and enforce lines of responsibility throughout the organization”. While the Board should approve the division of responsibilities between itself and senior management and the role of control functions, it should only approve the principles governing the lines of responsibility and accountability throughout the organization. The specific details of such division of responsibilities are a function of management.

3. Principle 3: Board’s own practices and structure

- Non-executive Chair of the Board (No 45): the Institute believes that the drafting of this paragraph could be improved by separating clearly two different issues: whether the Chair of the Board is an executive; and, whether the roles of CEO and Chair of the Board are combined in the same person. More importantly, we would like to note that while separation is the practice in many jurisdictions, it is not wrong *per se* to have executive Chairs of the Board or to combine such role with that of CEO. We fear, however, that because of the way the principle is drafted there would be a negative bias against this choice. As previously noted, the combination of the role is very common in some European and other jurisdictions and is a valid practice.
- In addition, the guidance could cite other measures that banks have adopted to minimize the potential impact on checks and balances. These include having a Board with a majority of independent members or to require that certain committees be composed predominantly of non-executive members (such as the Audit and Compensation committees).

³ <http://www.iif.com/download.php?id=ukBoiNBO8UE=>

- Audit Committee (Para 48): the IIF considers that some measure of proportionality should be used to determine the type of audit reporting that the specialized committee receives. In large banking groups, it would be unrealistic, and indeed counterproductive, to flood the audit committee with all the audit reports produced, which can go well beyond a thousand a year. Proportionality should be expected in order to make this an effective procedure.
- Risk Committee (Para 50): the IIF would suggest that focus should be on the risk oversight function itself, rather than on the operational means through which this is done. In particular, we note that because of the way the principle is drafted, there is the implication that the Audit and Risk committees should be separated. Therefore, we would suggest that while clearly the Board should perform risk oversight, it should be left to the Board's discretion to decide whether this is best left to a separate committee or should be assigned to the audit committee. Also, the guidance could clarify that review of various risks can be accomplished by more than one Board committee (i.e., even if the Board establishes a Risk Committee certain risks, such as operational or legal, may be overseen by another Board committee).
- Compensation Committee (Para 51): this paragraph is an additional instance where the roles of management and the Board are confused. We believe the role of the Compensation Committee is to oversee (but not set) the compensations system design.

Principle 4: Group Structures

- With respect to group structures (Para 59), we believe that a subsidiary should not be required to replicate the corporate governance structures of its parent; there may be cases where firm wide committees (e.g., audit or risk) may be more efficient than entity-specific committees. For instance, requiring non-executive or independent directors for subsidiaries or on their committees could be unnecessary.
- Role of the Parent Company's Board (Page 61): the Institute believes that the role of the Board of the parent company needs to be further clarified. In particular we would argue that in regard to governance structures and policies at the subsidiary level, the Board's role should be that of "approval" rather than "establishing" and "setting". Similarly, the requirement should be for the Board to define policies and procedures so that the Group monitors compliance by subsidiaries with all applicable governance requirements (as opposed to requiring that the Board itself perform this meticulous task, particularly in the case of large groups).

Principle 6: Risk Management

- Risk management vs. internal controls (Footnote 22): while we agree that the focus should be on having both functions achieve their objectives, it is also important that each function retains its identity and separate character. Therefore, the guidance should not promote the subordination of risk management exclusively as a control function with no real connection with business activities. In fact, such link (while preserving an independent risk management function) is essential for the risk function to perform its role effectively.
- Reporting (Para 67 - 70): following the same line of reasoning as above, the Institute believes that formal reporting of the risk function should be to executive management. Without limiting the need for access to the Board, this should be a fundamental ability for the risk function. Our

main concern is that by requiring a formal reporting line to the Board the risk function may turn into a purely control function, losing many of its essential features.

- Risk Mitigation (Para 67): We note that risk mitigation, in its strict sense, should not be a function of the CRO or risk management. Rather, business management is directly responsible for taking actions to reduce risk (if so instructed or if actions have gone over internal limits or guidelines for any reason). Risk management, however, should ensure that this mitigation takes place and measure its effects.
- “Dual hatting” (Para 69): we agree with the principle that the functioning of the CRO should not be compromised by him having conflicting responsibilities. However, it is important to note that such conflicting responsibilities will not necessarily arise if the CRO and CFO functions are combined (as a matter of fact, several industry corporate governance codes actually do permit the combination of these two roles). Whether these roles can actually be combined is actually a matter of span of control which is more dependant on the bank’s complexity than on its size. For this reason, we think that the restriction of dual hatting to small banks only (insofar the combination of the roles of CRO and CFO is concerned) might be too restrictive.
- Removal of CRO (Para 72): a balance between the roles of the Board and management is also necessary here. We believe that sufficient counterbalance is provided by requiring that the Board be informed of the removal of the CRO, without requiring previous approval for such removal⁴.
- Subsidiaries Risk Management (Para 83): we note that some subsidiaries, especially in corporate and investment banking, are fully integrated in the parent company’s risk management structure. This generally ensures a much better quality of risk management than the establishment of distinct risk management organisations. While the subsidiary management and Board remain legally responsible for the risk management of their company, it is entirely appropriate for them to delegate its day-to-day management, in whole or part, to the parent company. Indeed, this is expressly foreseen in some banking regulations in some countries. The paragraph, in relevant sections, should perhaps be revised accordingly: “While responsibility for the management of risk lies with local management and the Board, they may delegate risk operational management to a group function and rely on parent company models, systems and staff, provided that effective controls are in place.”

Principle 9: Boards and Audit and Control Functions

- Financial statements (Para 98): we note that in a number of jurisdictions, as a matter of law, only management is responsible for the preparation and fair presentation of financial statements. The guidance should clarify this (or at least, include the reference to “unless otherwise required by law”).

⁴ However, in some jurisdictions with a two-tier board system, where the supervisory Board has a role in selecting the senior management – including the CRO – there might be a more direct role for the Board in the removal of the CRO. However, flexibility should be preserved as noted in our main comment.

Principle 10: Compensation

- The Institute agrees with the objectives and main elements of the guidance on the issue of compensation. However, as a general comment, we would encourage the BCBS to establish realistic responsibilities to Boards in this area, without transferring to the Board responsibilities that pertain to management. In general, the role of the Board should be to “approve” compensation policies, rather than establishing them. Footnote 34 could clarify this further.

Principles 12-13: Complex or Opaque Corporate Structures

- The IIF understands the concerns driving the formulation of principles in regard to opaque and complex structures. However, as currently drafted, the guidance would require Boards to perform “daily management” of subsidiaries’ activities (e.g., several of the requirements in Para 119). The Principles should reflect the fact that Parent bank Boards are generally oversight bodies with no real involvement in daily management. In fact, in a complex financial group, it is unreasonable and impractical for a Board to be aware of the details of individual entities to the degree suggested. The Principles should recognize the concept of materiality, policy review and the ability to delegate. In addition, parent company involvement in the “daily management” of subsidiaries’ activities could trigger unlimited liability of the parent company for the subsidiaries’ obligations and thus result in a distortion of existing risk management structures. It is unreasonable, impractical and even counterproductive for a board to get involved in the details of these entities to the degree suggested. This of course should not be interpreted as avoiding adequate control of the activities of subsidiaries. Rather, the Board should establish policies and procedures so that the group has a robust oversight of the activities of all its elements and components.

Conclusion

The IIF believes that the official sector and the industry share the responsibility for ensuring the compliance with sound corporate governance standards in the financial sector. Therefore, the IIF welcomes the BCBS Consultative paper “*Principles for Enhancing Corporate Governance*” and reaffirms its commitment to the implementation of the recommendations set out in the Final Report of the IIF Committee on Market Best Practices (“Market Best Practices Report”), published in 2008, and towards a continuing effort and progress across the industry to reform its practices, including with respect to corporate governance, risk management, and compensation.

In this regard, an effective dialogue between the industry and the BCBS, as well as the adoption of a flexible approach where the principle of materiality and proportionality are fully applied will be crucial for achieving the objectives of the *Principles*.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'A. Portilla', with a large loop at the top and a horizontal line across the middle.

Andres Portilla
Deputy Director
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