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From: Prof. Alexander Kostyuk, Executive Director,
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Date: 16 April, 2010

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

Subject: Comments to the Consultative Document
“Principles for enhancing corporate governance”

Dear Sir/Madam.

I enclose our comments to your Consultative Document “Principles for enhancing corporate governance”. These comments have been prepared by the team of researchers at the International Research Center of Banking & Corporate Governance at Ukrainian Academy of Banking of the National Bank of Ukraine (Ukraine) consisting of Prof. Alexander Kostyuk, Mr. Dmitriy Govorun and Ms. Varvara Lysenko and Mr. Artyom Pnomaryov. We hope that the comments would be taken into consideration when approving the final Paper. Your feedback would be appreciated by us.

With the best regards,
Prof. Alexander Kostyuk

I. Remarks to the document.

In mentioned document an attempt of strengthening corporate governance in context of the financial crisis is made. In view of frequent mentions about compensation problems of the top management in banks the given document should touch compensation problems. Part 4 of the introduction, section «D» of the document is devoted to these questions. But, in the structure of the document the ways of strengthening of corporate governance compensation practices (2 principles from 14) are insufficiently highlighted.

Probably, it is necessary to pay attention to recommendations mentioned in this document to apply earlier published principles (FSF Principles for Sound Compensation Practices, April 2009), what is stipulated in point 4:

The banks should fully implement the Financial Stability Board's (FSB - formerly the Financial Stability Forum) Principles for Sound Compensation Practices¹ (FSB Principles) and accompanying Implementation Standards⁸ (FSB Standards) or the applicable national provisions that are consistent with the FSB Principles and Standards.)

Probably, it is better to identify this document as a separate document, which will not contain references to others (in which there will be similar references to others), and will represent synthesis of previous practices and recommendations according to a separate directions. It can be done with the help of inclusions (appendixes), which will contain explanations according to mentioned documents, i.e. to expand the document with help of explanations.

The same thing is also about document references - Compensation Principles and Standards Assessment Methodology, Basel Committee on Banking Supervision, January 2010 and others.

II. Remarks on principles.

Compensation.

Principle 10.

Point 104:

*The board is responsible for the overall design and operation of the compensation system for the entire bank. As such, those **board members who are most actively involved in the design and operation of the compensation system (e.g. as members of the board's compensation committee) should be independent**, non-executive members with substantial knowledge about compensation arrangements and the incentives and risks that can arise from such arrangements. Because compensation should be aligned with risk (as discussed in Principle 11 below), an understanding of the firm's risk measurement and management, and of how different compensation practices can impact the firm's risk profile, is important as well. **Board compensation committees should also***

¹ Italic words means that this part of sentence or abstract causes some questions

meet the criteria set forth in the “Governance” section of the FSB Standards, including working closely with the board’s risk committee to evaluate incentives arising from compensation and ensuring that an annual compensation review is undertaken.

Problem: It was necessary to specify the mentioned criteria in the given comments not to cause ambiguities about how should co-operate Compensation committee and Risk committee.

As for questions concerning interactions, a way of interaction between compensation committee and CRO (Chief Risk Officer) should be specified.

Proposals: fixed accent and mentioning of independent directors presence as element of objectivity and adequate evaluation - a right trend. But, it is important to mention concrete criteria of independence. It was mentioned in the document that an independent director should not be from among the present executives or from among an executives of interested organization etc. As a way of solving this question it can be creation a separate variant, without referring to other documents, where the independence criteria of independent directors of the Board of Directors, especially compensation committee, will be mentioned.

Point 106:

The compensation of the control function (e.g. CRO and risk management staff) should be structured in a way that is based principally on the achievement of their objectives and does not compromise their independence (e.g. compensation should not be substantially tied to business line revenue).

Problem: in this understanding it is important to identify the CRO performance evaluation mechanism (criteria as well), i.e. how, in which way CRO will get remuneration or other incentives.

In this understanding other issue appears – necessity to identify who determines those objectives and how to evaluate them. Here we have the necessity to write it earlier in section C “Risk management and internal controls”.

Principle 11.

*An employee’s compensation should be effectively aligned with prudent risk taking: **compensation should be adjusted for all types of risk**; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; **and the mix of cash, equity and other forms of compensation** should be consistent with risk alignment.*

Problem: the formulation «all types» should be changed, as a questions appears, - which types of risks? How many of them? How to consider them? (All risks it is impossible to consider).

Proposals: there should be pointed concrete list of risk types or reference to such list or its similarity in this document.

Problem: «An employee’s compensation» it is necessary to concretize and correct also, because not clearly it is all workers of bank (back office, front office etc.) or the executives, members of board of directors? Plus, in accompanying references to other documents the partial explanation about

who is responsible for indemnification of different levels of workers (FSB *Principles for Sound Compensation Practices*) is present, but this problem should be specified in the new document.

Point 110:

The mix of cash, equity and other forms of compensation (e.g. options) should be consistent with risk alignment and will likely vary across employees, depending on their position and role in the bank.

Problem: concerning issues of cash and other forms of remuneration («*and the mix of cash, equity and other forms of compensation*») some comments and explanations can be met in the separate document (Compensation Principles and Standards Assessment Methodology, Basel Committee on Banking Supervision, January 2010). But it is necessary to give explanations if there are some preferences.

Proposal: herein it is important to show, for example, a grid (as an extreme case) in which the dependence on a post and a role in bank specified in point 110 will be displayed, if it can be done in the universal approach comprehensible to many organizations.

Point 107:

*Since employees can generate equivalent short-term revenues while taking on vastly different amounts of risk in the longer term, **a bank** should ensure that variable compensation is adjusted to take into account the risks an employee takes...*

Problem: the formulation «*a bank*» should be replaced, as it is not clear who exactly - CEO, CRO, Compensation Committee or some other officer?

Proposal: its better refer to national law, where this function in most cases delegated to Board of Directors. So the formulations like “Shareholders and their representatives in the bank” instead “a bank” will be more suitable and clear.

Risks.

Principle 6.

Point 70:

*Formal reporting lines may vary across banks, but regardless of these reporting lines, the independence of the CRO is paramount. **While the CRO may report to the CEO or other senior management, the CRO should also report and have direct access to the board and its risk committee without impediment.** Interaction between the CRO and the board should occur regularly and be documented adequately. Non-executive board members should have the right to meet regularly - in the absence of senior management - with the CRO.*

Problem: it isn't described if the CRO a member of the board or not, in other words how it interacts with the Board and is a member of the Board or not.

Point 72:

If the CRO is removed from his or her position for any reason, this should be done with the prior approval of the board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor.

Problem: the issue of CRO removal from a post (position) is described, but question about who makes a decision in terms of hiring CRO is not mentioned, i.e. the mechanism of appointment, the statement and the general procedures connected with it. Probably, it is necessary to describe scheme more detailed.

Problem: the question of submission and place CRO in corporate governance structure is not accurately delineated.

Proposal: let suggest that the right of approving person to the CRO post belongs to the Board of Directors (as term officer means that this position is assigned) as representatives of interests of shareholders. In this case it would be rational if CRO could be taken for a Board of Directors. CRO should report to CEO and the Chairman of the Board as a whole. That's how the problem with removing CRO from the position can be solved – the Board of Directors makes decision about removing, but finally CRO become fired after approving such decision from shareholders (because of the questions about hiring contract). Other important issue is interaction with committees. Obviously, as a part of Board of Directors CRO have to interact with committees but with not crossing the control and executive functions.

#	TREATMENT	PROBLEM	PROPOSITION
1	31. Communication should be allowed to be channeled to the board - directly or indirectly (e.g. <...> through an ombudsman)	Mechanism of appointment of the ombudsman is not identified	We suggest that an ombudsman should be a representative of government structures. During one of the board meetings the members consider possible candidates and after that they make an offer to the chosen person to occupy the position.
2	37. The bank should have an adequate number and appropriate composition of board members.	Mechanism of forming of the board is not identified	
3	22. In discharging these responsibilities, the board <u>should</u> take into account the legitimate interests of shareholders, depositors and other relevant stakeholders.	Stated more like a recommendation, not an obligation	Replace "should" with "must".
4	36. In order to help board members acquire, maintain and deepen their knowledge and skills and to fulfill their responsibilities, the board should ensure that board members have access to programmes of tailored initial and ongoing education on relevant issues. The board should dedicate sufficient time, budget and other resources for this purpose.	The question of expediency of the trainings is not raised	To form Training Committee. Its responsibilities will include the control of distribution of the funds; concerning each training course with the object of its necessity.
5	23. "Duty of care" is often interpreted as requiring the board member to approach the affairs of the company in the same way that a "prudent man"	The term 'prudent man' used in the definition is quite controversial	Avoid using purely personal appeal and concentrate more on concrete professional qualities.
	would approach their own affairs.		
6	30 A bank's code of conduct should <...>. It is especially important that such a document disallows behavior that could result in the bank engaging in any improper or illegal activity, such as money laundering, fraud, bribery or corruption.	"Non-material bribes" (relationships between two parties that exceed the bounds of job descriptions and appear to be the hidden motive for taking this or that decision by one of the parties) are not considered; the list of illegal activities is not exhaustive.	Present all 'improper and illegal activities' in the form of the list that will cover all kinds of them
7		Bribery and corruption imply two parties while money laundering and fraud can be committed by one person only. As a result, money laundering and fraud are much harder to be documentary regulated.	Clearly differentiate improper activities. Make a special point in a document about two last categories.
8		Absence of punishment mechanisms.	Mechanisms should be described in a separate article.
9	42. <...> Assistance from <u>external facilitators</u> in carrying out board assessments can contribute to the objectivity of the process.	Duties and appointment procedure is not clear.	Identify the role and duties of external facilitators in the company's activity.
10	47. <...> It may be useful to consider occasional rotation of membership and chairmanship of such committees.	'Rotation of membership and chairmanship' appears to be a controversial point	
11	45. <...> where the roles of the chair of the board and CEO are vested in the same person <...>	Combination of positions of CEO and Chair of the Board in one person can cause	Exclude such situation on the level of the document

		conflicts of interests	
12	35. The board collectively should have <u>adequate</u> knowledge <...>	The term 'adequate' sounds very much vague	Identify the criteria of 'adequacy'.
13	34. The board should possess <...> <u>personal integrity</u> .	The term 'personal integrity' sounds very much vague	
14	31. <...> It may prove highly beneficial for banks to establish <...> <u>bona fide concerns</u> or observations of any violations.	The term 'bona fide concern' sounds very much vague	
15	54d. The formal written conflicts of interest policy should include a member's responsibility to abstain from voting on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfill duties to the bank may be otherwise compromised.	While taking part in the process of voting concerning this or that question, one of the members of the board might have certain material interest (e.g. CEO of a company that specializes in trainings takes part in voting regarding a training company for the bank to choose).	Before the board meeting named member should: 1) familiarize himself with the agenda; 2) identify possible risks and conflicts of interest for himself; 3) inform the chair of the board about probable negative outcomes so that to put off all the responsibility on his part. Further decision depends on the chair.
16	57. There is a potential conflict of interest where a bank is both owned by and subject to banking supervision by the state.	Probability of lack of coincidence between the interests of the state and a bank as a commercial structure	Delegate the responsibility of control concerning conflicts of interests to the appropriate body (e.g. Audit Committee)
17	Principle 2. Board members <...> should have a <u>clear understanding</u> of their role in corporate governance and be able to exercise sound and	Absence of differentiation between 'clear' and 'unclear'	"Clear understanding" should imply acting for the benefit of the bank, pursuing common goals and not placing purely
	objective judgment about the affairs of the bank.		personal interests in front of the common ones.

CONCLUSIONS:

- 1) Some articles (e.g. concerning money laundering, bribing, rotation in the committees etc.) have personal appeal and aimed at solving the problem of the identification of one's responsibilities, not "sticking to the position" and, as a result, not using the functions in the personal interests.
- 2) Situations, when the positions of CEO and chair of the board are vested in the one person (45) and when the board's member votes or abstain from voting on the question he has extra benefit (54d) cause the evident conflict of interest which can harm a bank, so they should be thoroughly considered.
- 3) There are terms that sound a bit vague and don't seem to have clear interpretations, so that can distort the picture of one's functions and give reasons their non-fulfillment.
- 4) Appearing of so called "non-material bribes" and impossibility of their exposure; lack of regulation on the documentary level releases from the mechanisms of control.