Basel Committee
on Banking Supervision

Consultative Document

Enhancing corporate governance for banking organisations

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Enhancing Corporate Governance for Banking Organisations

This document, when finalised, is intended to supersede the 1999 Basel Committee guidance on* Enhancing Corporate Governance for Banking Organisations*. Comments on this consultative document are welcome. Comments should be submitted to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland by 31 October 2005. Comments may also be submitted via e-mail: baselcommittee@bis.org[1] or by fax: +41 61 280 9100. Comments on this paper will not be posted on the BIS website.

I. Introduction

1. The issue of corporate governance continues to attract considerable national and international attention. The Basel Committee on Banking Supervision[2] (the Committee) published guidance in 1999 to assist banking supervisors in promoting the adoption of sound corporate governance practices by banking organisations in their countries.[3] This guidance drew from principles of corporate governance[4] that were published earlier that year by the Organisation for Economic Co-operation and Development (OECD) with the purpose of assisting governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for financial market regulators and participants in financial markets.

2. Since the publication of those documents, issues related to corporate governance have continued to attract considerable national and international attention in light of a number of high-profile breakdowns in corporate governance. In response to requests to assess the OECD principles in view of such developments, the OECD published revised corporate governance principles in 2004. Recognising that revised guidance could also assist banking organisations and their supervisors in the implementation and enforcement of sound corporate governance, and in order to offer practical guidance that is relevant to the unique characteristics facing banking organisations, the Committee is publishing this revision to its 1999 guidance. This paper also presents some considerations for corporate governance related to the activities of banking organisations that are conducted through

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1 Please use this e-mail address only for submitting comments and not for correspondence.

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, Spain, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.

3 See *Enhancing Corporate Governance for Banking Organisations*, Basel Committee on Banking Supervision, September 1999.

4 See *OECD Principles of Corporate Governance*, revised April 2004, originally issued June 1999. The OECD principles constitute one of the twelve key standards of the Financial Stability Forum for sound financial systems.

structures that may lack transparency, or in jurisdictions that pose impediments to information flows.

3. This paper is neither intended to comprise a new element of, nor to add additional requirements to, the revised international framework for bank capital adequacy (Basel II).[5] The Committee nevertheless recognised the importance of sound corporate governance when it published the Basel II Framework. The board of directors and senior management at each institution have an obligation to understand the risk profile of that institution and ensure that capital levels adequately reflect such risk. It is particularly important that the board and senior management of institutions adopting the most advanced approaches for credit and operational risk ensure that the use of complex risk models is subject to effective oversight. Pillar 2 requires bank management to ensure that adequate capital is maintained to support risks beyond the minimum requirements, that a sound system of oversight and control is in place and that risk management procedures are appropriate in relation to the institution's risk profile. The board of directors also needs to ensure adequate disclosure of key information under Pillar 3 so that market discipline becomes an integral part of the control framework for senior management.

4. Sound practice papers issued by the Basel Committee in recent years describe the roles of the board of directors and senior management in managing risk and underscore the need for banks to set strategies for their operations and establish accountability for executing these strategies. These papers have highlighted strategies and techniques for managing risk and include a number of common elements that are basic to sound corporate governance. Among the elements emphasised in these papers that contribute to effective corporate governance are: the development of corporate values, codes of conduct, and other standards of appropriate behaviour[6], as well as 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; establishment of a mechanism for interaction and cooperation among the board of directors, senior management and auditors; strong control systems, including internal and external audit functions, risk management policies and 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); financial and managerial incentives to act in an appropriate manner in the form of compensation, promotion and other recognition; and appropriate information flows internally and to the public.

5. This paper sets forth a broad framework of fundamental corporate governance principles to guide the actions of the directors, managers and supervisors of a diverse range of banking organisations[7] in a number of countries and legal systems, including both Basel Committee member countries and non-member countries. Other fundamental issues related to corporate governance of publicly listed companies, such as effective shareholder rights,

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[5] See *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, Basel Committee on Banking Supervision, June 2004.

[6] While a number of banking organisations engage in activities related to what has been termed "corporate social responsibility", references to values, codes of conduct and ethical standards in this guidance are not generally intended to apply to such activities.

[7] The terms "bank" and "banking organisation" as used in this document generally refer to banks, holding companies or other companies considered by banking supervisors to be the parent of a banking group under applicable national law as determined to be appropriate by the entity's national supervisor. This paper makes no distinction in the application to banks or banking organisations.

are addressed in the OECD principles. The principles set forth in this paper are fundamental underpinnings of sound corporate governance for the broad range of countries and banking legal structures. The Committee recognises that some countries have found it appropriate to adopt legal frameworks and standards (e.g. for publicly traded firms) that are more extensive and prescriptive than the principles set forth in this paper. Such frameworks and standards are particularly relevant for large financial institutions, where financial difficulties resulting from corporate governance failures may potentially lead to major widespread problems in the financial system.

6. The Basel Committee is issuing this paper to supervisory authorities and banking organisations worldwide in the belief that it will promote the adoption of sound corporate governance practices by banking organisations in their countries, commensurate with their size, complexity and risk profiles, and assist supervisors in assessing the quality of the banking organisations' corporate governance frameworks. Corporate governance standards for banks should be appropriate to the size and complexity of the bank, and should be well-defined and efficiently enforced.

7. This guidance refers to a governance 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, the role of the board of directors is performed by an entity known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence. 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 the management and oversight functions within a bank. These approaches to boards of directors and senior management are sometimes referred to as corporate governance "structures" in this paper. Recognising that different structural approaches to corporate governance exist across countries, this paper encourages practices that can strengthen corporate governance under diverse structures.

II. Overview of bank corporate governance

8. Corporate governance for banking organisations is arguably of greater importance than for other companies, given the crucial financial intermediation role of banks in an economy, the need to safeguard depositors' funds and their high degree of sensitivity to potential difficulties arising from ineffective corporate governance. Effective corporate governance practices, on both a system-wide and individual bank basis, are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole. Bank failures can pose significant public costs and consequences due to their potential impact on deposit insurance mechanisms and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. Indeed, banks and other financial companies may lose large amounts of money in a short period in the case of events such as fraud. In addition, poor corporate governance can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a liquidity crisis or a run on deposits. Banks also typically have access to confidential customer information, which can potentially be misused by employees for personal gains. Moreover, review and analysis of the investments, activities, risk exposures and financial statements of banks may in some cases be more complex than such reviews of other companies for several reasons, including the unrated, borrower-specific nature of a bank's loan portfolio, as well as valuation challenges. In light of these sensitivities, minimum standards of corporate governance for banks should therefore be more ambitious than for non-financial firms.

9. The OECD principles define 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 its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy."

10. 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, which affects how banks:

- Set corporate objectives (including generating economic returns to owners);
- Run the day-to-day operations of the business;
- Meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders[8];

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[8] Supervisors, governments and depositors are among the stakeholders due to the unique role of banks in national and local economies and financial systems, and the associated implicit or explicit deposit guarantees.

- Align corporate activities and behaviour 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.

11. Effective corporate governance is an essential element in the safe and sound functioning of a bank. As the functions of the board of directors and senior management with regard to setting policies, implementing policies and monitoring compliance are key elements in the control functions of a bank, effective oversight of the business and affairs of a bank by its board and senior management contributes to the maintenance of an efficient and cost-effective supervisory system. Intra-group outsourcing cannot result in delegation of the responsibility of the directors and senior management of the bank to the group entities providing the outsourced services. Sound corporate governance contributes to the protection of depositors and creditors of the bank and permits the supervisor to place more reliance on the bank's internal processes. Supervisory experience underscores the importance of having the appropriate levels of accountability and checks and balances within each bank. In addition, in situations where a bank is experiencing problems, or where significant corrective action is necessary, the board's role is intensified as the supervisor will require its substantial involvement in seeking solutions and overseeing the implementation of corrective actions.

12. There are unique corporate governance challenges posed where bank ownership structure either lacks transparency or where there are insufficient checks and balances on inappropriate activities or influences of controlling shareholders. The Committee is not suggesting that the existence of controlling shareholders is in and of itself inappropriate. Indeed, controlling shareholders can be beneficial resources for a bank, and in many markets and for many small banks this is a quite common and appropriate ownership pattern that does not raise concerns on the part of licensing authorities. It is nevertheless important that supervisors take steps to ensure that such ownership structures do not impede sound corporate governance. In particular, supervisors should have the ability to assess the fitness and propriety of bank owners.[9]

13. Good corporate governance requires an appropriate and effective legal, regulatory, and institutional foundation. A variety of factors, including macro-economic policies, the system of business laws, and accounting standards, can affect market integrity and overall economic performance. Such factors, however, are sometimes outside the scope of banking supervision.[10] Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so.

14. Corporate governance arrangements, as well as legal and regulatory systems, vary widely between countries. Nevertheless, sound governance can be achieved regardless of the corporate form used by a banking organisation so long as several essential functions are in place. There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure appropriate checks and balances:

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[9] For further information on "fit and proper" tests, see Basel Committee on Banking Supervision document *Core Principles for Effective Banking Supervision*, September 1997, and the related *Core Principles Methodology*, October 1999. The core principles and methodology are under review for possible revision as of the publication of this document.

[10] The foundations of effective corporate governance are comparable to the preconditions for effective banking supervision cited in section II of *Core Principles for Effective Banking Supervision*. Like the foundations for effective corporate governance, the preconditions for effective banking supervision are vitally important but are often outside the scope and legal authority of the banking supervisor.

(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, compliance and audit functions. In addition, it is important that key personnel are fit and proper for their jobs. Although government ownership of a bank has the potential to alter the strategies and objectives of the bank, a government-owned bank will face many of the same risks associated with weak corporate governance. Consequently, the general principles of sound corporate governance should also be applied to government-owned banks. Likewise, these principles apply to banks with other unique ownership structures, for example those that are family-owned, and to those that are not publicly listed.

III. Sound corporate governance principles

15. As discussed 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 principles that could help to avoid such problems. These principles 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

16. 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 strategic objectives and ethical standards that will direct the ongoing activities of the bank, taking into account the interests of stakeholders. As important as, if not more important than, any written set of values and high ethical standards is a corporate culture that mandates and provides incentives for ethical behaviour. In this regard, the board should take the lead in establishing the “tone at the top” and approving ethical standards and corporate values for itself, senior management and other employees. The consistent practice of high ethical standards is in the bank’s best interests and will enhance its credibility and trustworthiness in its day-to-day and long-term operations. It is especially important that the standards address corruption (including bribery), self-dealing and other unethical or illegal behaviour in banks’ internal and external activities.

17. The corporate values should recognise the critical importance of timely and frank discussion of problems. In this regard, employees should be encouraged and able to freely communicate concerns about illegal, unethical or questionable practices to the board or an independent committee thereof, as well as to senior management, without fear of reprisal. Because illegal, unethical or questionable practices can have a detrimental impact on a bank’s reputation, it may prove highly beneficial for banks to establish procedures for employees to communicate material concerns directly or indirectly (e.g. through an audit or ethics committee or an ombudsman) and confidentially to the board independent of the internal “chain of command.” Any process for reporting material concerns should include an option for employees to make their concerns known anonymously. The board and senior management should appropriately protect employees who report illegal, unethical or questionable practices from direct or indirect disciplinary action, or other adverse consequences taken at the behest of the bank.

18. The board of directors should ensure that senior management implements policies to (1) identify, (2) prevent or appropriately manage, and (3) appropriately disclose potential conflicts of interest which may arise as a result of the various activities and roles of the bank (e.g. as a lender, provider of investment and ancillary services, and proprietary trader). Such policies should ensure that the bank’s business activities that may give rise to conflicts of interest are carried out with a sufficient degree of independence from each other by, for example, establishing information barriers between different activities and by providing for separate reporting lines and internal controls. In addition, particular care should be taken in such instances to ensure that all information addressed to clients or potential clients (e.g. information about the nature and cost of services provided, or recommendations regarding financial instruments and investment strategies) is clear, fair and not misleading. Similarly, conflicts between the personal interest of directors or senior managers and that of the bank or its customers should be identified and either prevented or managed and appropriately disclosed.

19. Conflicts of interest may also arise when a bank is part of a broader group structure. For example, where the bank is part of a group, reporting lines and information flows between the bank, its parent and/or other subsidiaries of the parent can lead to the emergence of similar conflicts of interest (e.g. sharing of potential proprietary, confidential or otherwise sensitive information from different entities). A bank's board of directors should ensure that senior management implements policies to identify, prevent or manage, and disclose as appropriate the conflicts of interest which may arise as a result of its affiliation or transactions with other entities within the group.

20. There is a potential conflict of interest where a bank is both owned by and subject to banking supervision by the state. In such instances, there should be full administrative separation of the ownership and banking supervision functions in order to try to minimise political interference in the supervision of the bank.

21. The board of directors should also ensure that senior management implements strategic policies and procedures designed to promote professional behaviour and integrity. The board should also ensure that senior management implements policies that prohibit (or appropriately limit) activities and relationships that diminish the quality of corporate governance, such as:

- Conflicts of interest (as discussed above);
- Lending to officers, employees or directors (i.e. where allowed by national law). Where internal lending occurs, it should be limited to lending consistent with market terms or terms offered to all employees and may be restricted to certain types of loans, reports of insider lending should be provided to the board, and such lending should be subject to review by internal and external auditors and supervisors; and
- Providing preferential treatment to related parties and other favoured entities (e.g. lending on favourable terms, covering trading losses, waiving commissions).

22. The bank should maintain an effective compliance function that routinely monitors compliance with rules, regulations and policies to which the bank is subject and ensures that deviations are reported to an appropriate level of management or, if appropriate, to the board of directors.[11]

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

23. Effective boards of directors clearly define the authorities and key responsibilities for themselves, as well as for 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. The board of directors is responsible for overseeing management's actions and consistency with board policies as part of the checks and balances embodied in sound corporate governance. Senior management is responsible for delegating responsibilities to the staff and establishing a management structure that promotes accountability, while remaining cognisant of senior management's obligation to oversee the exercise of such delegated responsibility and its ultimate responsibility to the board for the performance of the bank.

[11] See *Compliance and the compliance function in banks*, Basel Committee on Banking Supervision, April 2005.

24. The same principles apply where the bank is part of a broader group structure, either as the parent company or as a subsidiary. However, the group dimension adds a number of issues that are relevant in the corporate governance perspective in that it is likely to affect to a certain extent the corporate governance structure and activities of both parent and subsidiary boards. The corporate governance responsibilities of both the bank and its parent should be respected. The parent board or senior management – acting in the discharge of its own corporate governance responsibilities – is charged with setting the general strategy and policies of the group and its subsidiaries and for determining what governance structure for its subsidiaries would best contribute to an effective chain of oversight for the group as a whole. The board of a subsidiary bank retains its corporate governance responsibilities for the bank itself, including the soundness of the bank and the protection of the interests of its depositors, and must ensure that the bank complies with its legal and regulatory obligations.

25. In the discharge of their corporate governance responsibilities, parent boards should be aware of the material risks and issues that might affect the constituent entities of the organisation and should, therefore, exercise adequate oversight over the activities of the subsidiaries. While the parent board's responsibilities do not prejudice or diminish the corporate governance responsibilities of the board and senior management of the subsidiary as set out in this paper, unnecessary replication of corporate governance structures and activities can be avoided through adequate integration and co-ordination.

26. The group dimension also gives rise to a number of challenges for the bank as well as its supervisors.[12] For example, where the bank is a subsidiary of a parent company, the corporate governance structures and activities of the bank may be integrated with, and influenced by, those of the parent company or other subsidiaries. Further, excessive intra-group outsourcing could lead to the situation where the bank becomes overly reliant on affiliates or third parties for important functions. Substantial intra-group outsourcing of operational functions in relation to internal audit, compliance, and risk management, or of other operational functions, does not eliminate the bank's obligations with respect to setting up and maintaining adequate oversight functions (without undue replication).

27. This situation presents a regulatory challenge especially where a bank is experiencing problems or where significant corrective action is necessary; in these situations the supervisor requires significant and meaningful involvement of the bank's board in seeking solutions and implementation of corrective actions. While parent-level matrix and business line management structures that do not coincide with the bank's legal entities may serve important business purposes of the overall organisation, such structures can nevertheless pose challenges to the effective corporate governance of the bank. In such cases, the bank's board, senior management and its internal control functions should ensure that the decisions of such matrix and business line management structures are consistent with the bank's corporate governance responsibilities.

28. The group dimension can also create conflicts of interest among the entities within the group. These conflicts should be identified and adequately managed consistent with safe and sound banking practices, as well as applicable laws and regulations, at the appropriate level. The board of directors of the group should establish and appropriately disclose a policy for transactions and other contractual relationships between the related companies. This

[12] While these challenges and the principles discussed in the paper are relevant to banking groups generally, the supervisors of regulated bank holding companies generally will factor these considerations into their supervision of bank holding companies pursuant to their national legal and supervisory frameworks for the oversight of bank holding companies.

policy should ensure through adequate procedures that transactions with related parties, in particular with shareholders, executive officers or members of the board, are not made on terms contrary to the interest of the bank and its other stakeholders. In jurisdictions that provide for consolidated supervision of a regulated parent company, these issues are typically addressed through the supervisory program.

Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are able to exercise sound independent judgment about the affairs of the bank

29. The board of directors is ultimately responsible for the operations and financial soundness of the bank. Boards of directors and their individual members add strength to the corporate governance of a bank when they:

- Understand their oversight role and their fiduciary "duty of loyalty" and "duty of care" to the bank and its shareholders;
- Avoid conflicts of interest, or the appearance of conflicts, in their activities with, and commitments to, other organisations;
- Recuse themselves from decisions when they have conflicts of interest that make them incapable of properly fulfilling their fiduciary duties;
- Are able to commit sufficient time and energy to fulfilling their responsibilities;
- Are of a size that allows for efficiency and real strategic discussion;
- Continue to develop and maintain an appropriate level of collective expertise as the bank grows in size and complexity;
- Periodically assess the effectiveness of their own governance practices, including nomination and election of board members, determine where weaknesses exist, and make changes as necessary;
- Select, monitor and, where necessary, replace key executives, while ensuring that the bank has an appropriate plan for executive succession, and determining that any intended successor(s) are qualified, fit and proper to manage the affairs of the bank;
- Serve as a checks and balances function vis-à-vis the senior management of the bank by exercising their duty and authority to question and insist upon straightforward explanations from management, and receive on a timely basis sufficient information to judge the performance of management;
- Meet regularly with senior management and internal audit to establish and approve policies, establish communication lines and monitor progress toward corporate objectives;
- Promote bank safety and soundness, understand the regulatory environment and ensure the bank maintains an effective relationship with supervisors;
- Provide sound and objective advice, and recommend sound practices gleaned from other situations;
- Contribute special expertise in overseeing a bank's activities which might not be available in the rest of the parent or group;
- Do not participate as the board of directors in day-to-day management of the bank; and

- Exercise due diligence in the hiring and oversight of external auditors in jurisdictions where this is the responsibility of the board (in some jurisdictions, external auditors are hired directly by shareholders).

30. Banks should have an adequate number and appropriate composition of directors who are capable of exercising judgment independent of the views of management or political or other outside interests.[13] In addition, the board of directors has a fiduciary responsibility to protect the bank from illegal or inappropriate actions or influences of dominant or controlling shareholders that are detrimental or not in the best interest of the bank and its shareholders. 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. This is particularly important in areas where there is a risk that the board of directors would be dominated by senior management or political influences, where there are influences on the board to take action that is not in the bank's best interest (although it may be in the personal interest of insiders or major shareholders), or where there is a potential for conflict of interest in key areas. Examples of such key areas include ensuring the integrity of financial and non-financial reporting, review of related-party transactions, nomination of board members and key executives, and board and key executive compensation. Qualified independent directors can bring new perspectives from other businesses that may improve the strategic direction given to management, such as insight into local conditions, and can also be significant sources of management expertise.

31. The board should have sound knowledge of each of the types of material financial activities the bank intends to pursue. In some cases, however, bank directors may not have detailed knowledge of banking, finance and related topics. While the lack of such knowledge should not preclude an otherwise qualified individual from serving on the board, in such cases banks are encouraged to implement programs of targeted training for board members in order to better enable them to fulfil their responsibilities. In addition, the board should have sufficient collective knowledge and expertise to enable effective governance and oversight.

32. Controlling shareholders (e.g. where a bank is state- or family-owned, or otherwise not listed on an exchange) have considerable powers to appoint members of the board of directors. In such cases, it is useful to bear in mind that the board and its directors have a fiduciary responsibility to the company and to all of its shareholders. In the case of state-owned banks, the government should not be involved in the day-to-day management of the bank, the independence of the board should be respected, and the board should be allowed to exercise its fiduciary responsibilities independent of political influence which could lead to conflicts of interest (e.g. when directors are state officials or have explicit political interests). This does not deny the right of the state as owner, however, to set overall objectives for the bank.[14]

33. In a number of countries, bank boards have found it beneficial to establish certain specialised committees to advise the board. In the interest of greater transparency and accountability, where such committees are established, their mandate, composition

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[13] Definitions of what constitutes "independence" for directors vary across different legal systems, and are often reflected in exchange listing requirements and supervisory standards. The key characteristic of independence is the ability to exercise objective judgment, regardless of board structures or ownership patterns and practices in a particular country. The extent to which supervisors establish stringent tests of either independence or non-independence for bank directors may depend in part on the extent to which there is a party or parties who are in a special position to influence the bank.

[14] Further guidance for the state in exercising its ownership function may be found in the *OECD Guidelines for the Corporate Governance of State-Owned Enterprises*, April 2005.

(including members who are considered to be independent) and working procedures should be well-defined and subject to disclosure. It may be useful to consider occasional rotation of membership and chairmanship of such committees.

34. The Committee presumes that large, internationally active banks will have an *audit committee* or equivalent structures (e.g. a statutory board of auditors) responsible for similar functions. The audit committee typically is responsible for providing oversight of the bank's internal and external auditors; approving their appointment[15], compensation and dismissal; reviewing and approving audit scope and frequency; receiving audit 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. To achieve sufficient objectivity and independence, this committee should be comprised of a majority of board members who are not executives of the bank. The audit committee often consists solely of independent, non-executive directors. Where executives do serve on the audit committee, to promote frank discussion it may be beneficial for the non-executive members of the audit committee to meet separately. It may also be beneficial for appointment or dismissal of internal and external auditors to be made only by a decision of the independent, non-executive audit committee members. At a minimum, the chairman or at least one other member of the audit committee should possess expert knowledge - commensurate with the complexity of the banking organisation and duties performed - in financial reporting, accounting or auditing, and all members should have backgrounds compatible with the duties of the committee.

35. Among the other specialised committees that have become increasingly common are the following:

- *Risk management committee* - providing oversight of senior management's activities in managing credit, market, liquidity, operational, legal, compliance, reputational and other risks of the bank. (This role should include receiving from senior management periodic information on risk exposures and risk management activities).
- *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, as reflected in the formulation of compensation policy.
- *Nominations/corporate governance committee* – providing assessment of board effectiveness and directing the process of renewing and replacing board members.

Ensuring that there is appropriate oversight by senior management

36. Senior management consists of a core group of individuals responsible for the day-to-day management of the bank, including, for example, the chief financial officer and division heads. These individuals should have the necessary skills to manage the business under their supervision as well as have appropriate control over the key individuals in these areas.

37. Senior managers contribute a major element of a bank's sound corporate governance by overseeing line managers in specific business areas and activities consistent with policies and procedures set by the bank's board of directors. One of the key roles of

[15] In some jurisdictions, external auditors are appointed directly by shareholders, with the board only making a recommendation.

senior management is the establishment, under the guidance of the board of directors, of an effective system of internal controls.[16] Even in very small banks, for example, key management decisions should be made by more than one person ("four eyes principle"). Management situations to be avoided include senior managers who are:

- Inappropriately involved in detailed business line decision-making;
- Assigned an area to manage without the necessary prerequisite skills or knowledge;
- Unwilling or unable to exercise effective control over the activities of apparent "star" employees. This is especially problematic where managers fail to question employees who generate returns that are out of line with reasonable expectations (e.g. where supposedly low-risk, low-margin trading activity generates unexpectedly high returns) for fear of losing either revenue or the employee.

Effectively utilising the work conducted by internal and external auditors, as well as other control functions, in recognition of their critical contribution to sound corporate governance

38. The role of independent, competent and qualified auditors and other control functions (including the compliance and legal functions) is vital to the corporate governance process in order to achieve a number of important objectives. These include identifying problems with a company's risk management and internal control systems and ensuring that the bank's financial statements fairly represent the financial position and performance of the company in all material respects. The board and senior management can enhance their effectiveness by:

- Recognising the importance of the audit and internal control processes and communicating their importance throughout the bank;
- Taking measures that enhance the independence and stature of auditors, including prohibiting, appropriately limiting or disclosing fees paid to audit firms or their affiliates for non-audit services;
- Encouraging, consistent with national standards, the lead auditor to take responsibility for other external audits conducted within a company and its global operations, so as to minimise the risk of gaps in the scope or conduct of audit activities;
- Ensuring that auditors understand their duty to the bank and its stakeholders to exercise due professional care in the conduct of audits;
- For state-owned banks, maintaining a dialogue as appropriate with state supreme audit institutions responsible for auditing the bank, as well as state controllers and external auditors, as appropriate;
- Considering rotation of external auditors or, at a minimum, rotation of the lead audit partner, even if not legally required;
- Utilising, in a timely and effective manner, the findings of auditors and requiring timely correction of problems by management;

[16] See *Framework for Internal Control Systems in Banking Organisations*, Basel Committee on Banking Supervision, September 1998.

- Ensuring the independence of the auditor through reporting to the board, or the board's audit committee; and
- Engaging external auditors to judge the effectiveness of key internal controls.

39. It is a sound practice to consider direct reporting of the internal audit function to the board of directors through an audit committee or other structures (e.g. a statutory board of auditors) comprising a majority of independent members, as well as direct (but not exclusive) reporting from the compliance and legal staffs to the board. It may be beneficial for independent directors to meet in the absence of bank management at least annually with the external auditor and the heads of the internal audit, compliance and legal functions. This can strengthen the ability of a bank's board of directors to oversee management's implementation of the board's policies and to ensure that a bank's business strategies and risk exposures are consistent with risk parameters established by the bank's board of directors.

40. The board should recognise and acknowledge that the internal and external auditors and others who perform control functions are of critical importance to them. 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. Senior management should also recognise the importance of effective internal and external audit functions to the long-term soundness of the bank.

Ensuring that compensation policies and practices are consistent with the bank's ethical values, objectives, strategy and control environment

41. Failure to link incentive compensation for members of the board of directors and senior management to the long-term business strategy can result in actions that run counter to the interests of the bank and its stakeholders. This could be the case where, for example, business is booked based upon volume and/or short-term profitability to the bank with little regard to short- or long-term risk consequences.

42. The board of directors should determine or approve, where appropriate subject to prior shareholder approval, the compensation of members of the board, senior management and other key personnel, and should ensure that such compensation is consistent with the bank's culture, control environment, and long-term objectives and strategy. It may be appropriate for remuneration policies to be handled by a committee of the board composed wholly or by a majority of independent directors to mitigate potential conflicts of interest and provide assurance to shareholders and other stakeholders.

43. In light of the oversight role and checks and balances function of the board vis-à-vis senior management as discussed above, the remuneration of the non-executive directors, especially those who are members of board committees such as the audit or risk management committee, should take into account their responsibilities and time commitments, but should not be related to the short-term performance of the bank.

44. Where executive directors and key personnel are eligible for performance-related incentives, their compensation should be subject to relevant and objective conditions designed to enhance long-term corporate value. 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. Likewise, remuneration policies should specify terms under which board members and key executives may hold and trade stock of the bank, as well as procedures to be followed in granting and re-pricing of options where these are a material component of overall compensation.

Conducting corporate governance in a transparent manner

45. Transparency is essential for sound and effective corporate governance. As set out in existing Basel Committee guidance on bank transparency[17], it is difficult for shareholders, other stakeholders and market participants to effectively monitor and properly hold accountable the board of directors and senior management when there is a lack of transparency. This happens in situations where the shareholders, other stakeholders and market participants 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. This is particularly an issue where complex cross-shareholdings foster opacity in a manner that impedes effective market and supervisory oversight.

46. While publicly traded companies generally are required to provide full, accurate and timely disclosure of material information to investors, both publicly-traded and privately-held banks should be required to provide such disclosure to supervisors and, as appropriate under national law, to other stakeholders. Although market discipline may be less relevant for privately held banks, especially those that are wholly owned, such banks can nevertheless pose the same types of risk to the financial system as publicly traded banks through various activities, including their participation in payments systems and acceptance of retail deposits. Appropriate disclosure facilitates market discipline and sound corporate governance, as well as enhancing the ability of supervisors and other stakeholders to more effectively monitor the safety and soundness of such banks.

47. Timely and accurate public disclosure, for example on a bank's public website and in its annual report, is desirable in the following areas[18]:

- Board structure (bylaws, size, membership, selection process, qualifications, other directorships, independence, material interests in transactions or matters affecting the bank, and committee membership, charters and responsibilities) and senior management structure (responsibilities, reporting lines, qualifications and experience);
- Basic organisational structure (major share ownership and voting rights, beneficial owners[19], major shareholder participation on the board or in senior management positions, line of business structure, legal entity structure, shareholder meetings);
- Information about the incentive structure of the bank (remuneration policies, executive compensation, bonuses, stock options);
- The bank's code or policy of business conduct and/or ethics (including any waivers, if applicable), as well as any applicable governance structures and policies (in particular, the content of any corporate governance code or policy and the process by which it is implemented, as well as a self-assessment by the board of its performance relative to this code or policy);
- Where a bank is state-owned, the overall objectives of state ownership, including any special obligations of the bank for social or public policy purposes and whether

[17] See *Enhancing Bank Transparency*, Basel Committee on Banking Supervision, September 1998.

[18] This discussion of transparency should be viewed as complementary to the specific disclosures required for banks that adopt the Basel II capital framework.

[19] Where information about beneficial owners is not known to the bank or may not be publicly disclosed, at a minimum such information should be obtainable by regulatory and enforcement agencies and/or through the judicial process.

these obligations are financed, as well as the state's ownership policy and role in corporate governance; and

- Nature and extent of transactions with affiliates and related parties, including any bank matters for which members of the board or senior management have material interests either directly, indirectly, or on behalf of third parties.[20]

48. The full (annual) financial statement, with supporting notes and schedules, should be required to be provided to customers, depositors and supervisors in order to provide such stakeholders with a clear and comprehensive picture of the financial standing of the bank.[21]

Maintaining an understanding of the bank's operational structure, including operating in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure")

49. Corporate governance challenges arise where banks operate through structures that lack or impair transparency. Banks may choose to operate in a particular jurisdiction[22] or may establish complex structures (e.g. special purpose vehicles or corporate trusts), often for legitimate and appropriate business purposes. Operating in such jurisdictions or through such structures may, however, pose financial, legal, and reputational risks to the banking organisation; impede the ability of the board of directors and senior management to conduct appropriate business oversight; and hinder effective banking supervision. Consequently, banks' boards of directors should have in place policies and procedures to ensure that such structures or activities comply with relevant laws and regulations, that the board considers the appropriateness of and sets limits on operations in such jurisdictions or the use of such structures, and that senior management identifies and manages the full range of risks associated with such structures or activities. The board of directors and senior management should document this process of consideration, authorisation and risk management to make this process transparent to auditors and supervisors. Countries should work to adopt laws and regulations enabling bank supervisors to obtain and analyse the documentation of this bank analysis and authorisation process and to take appropriate supervisory action to address deficiencies and inappropriate activities when necessary.

50. In addition to the direct risk arising from operating in jurisdictions or conducting business through structures that lack or impair transparency, banks may also be exposed to risk indirectly when they perform certain services or establish opaque structures on behalf of customers. 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 serve the legitimate business purposes of customers, in some cases customers may use products and activities provided by banks to engage in illegal or unethical activities. This can, in turn, pose significant legal and reputational risks to banks that provide such services. Banks that engage in such

[20] As part of its standards improvement activity, the International Accounting Standards Board (IASB) has revised its standard dealing with related party transactions. This standard focuses on strengthened definitions for related parties and enhanced disclosures to promote user understanding of the impacts of related party transactions on an enterprise's financial results. For further details, refer to IASB International Accounting Standard No. 24, *Related Party Disclosures*.

[21] In some jurisdictions, banks are required to provide only partial or abridged financial statements to customers, depositors and supervisors. This may limit the disclosure of meaningful clarifications of the financial statement as well as disclosure of more qualitative issues, thereby impeding transparency and market discipline.

[22] This could include offshore financial centres and onshore jurisdictions in which a lack of transparency and weak enforcement mechanisms foster opacity and hinder effective management and supervision.

activities should therefore have policies and procedures in place to carefully identify and manage all material risks arising from such activities.

51. In this regard, the board of directors should take steps to ensure that the risks of such activities are well-understood and managed:

- The board should ensure that senior management follows clear policies regarding the conduct of activities through corporate structures or in jurisdictions that impair transparency;
- The audit committee of the parent institution should supervise the internal audit of controls regarding these structures and activities, and should report findings annually, or whenever material events or shortcomings are identified, to the board of directors; and
- Appropriate policies, procedures and strategies should be in place governing the approval of complex financial structures, instruments or products used or sold in any business unit of the bank. Furthermore, the board should evaluate the bank's use and/or sale of these structures, instruments or products periodically as part of its regular review of management. Complex financial structures, instruments or products for which the financial, legal and reputational risks arising from their use or sale cannot be properly assessed and managed should not be approved.

52. The board and senior management can enhance their effectiveness by requiring that internal control reviews include not only "core" banking businesses, but also activities conducted in jurisdictions, or through structures (either on the bank's own behalf or on behalf of customers) that lack transparency. These reviews should include, for instance, regular inspection visits by the internal audit department, review of activities to ensure that they are in line with their initial intended purpose, review of compliance with applicable laws and regulations, and assessment of legal and reputational risks arising from those activities or structures.

53. While the board of directors and senior management are responsible for identifying and managing material risks arising from all of a bank's global activities, they should conduct an enhanced level of due diligence in instances where a bank operates in jurisdictions or through complex structures, or provides such services to customers, that reduce transparency and potentially impede effective supervision. In this regard, the board, or senior management consistent with guidance from the board, should:

- Regularly assess the need to operate in jurisdictions or through complex structures that reduce transparency;
- Identify, measure and assess all material risks, including legal and reputational risks, arising from such activities;
- Establish processes and policies for the approval of transactions and new products, especially related to such activities (e.g. applicable limits, measures to mitigate legal or reputational risks, and information requirements);
- Set forth clear corporate governance expectations and responsibilities for all relevant entities within the banking organisation;
- Define and understand the purpose of such activities, and ensure that the actual exercise of these activities is consistent with their intended purpose;
- Ensure that information regarding these activities and the risks involved is readily available to the bank's head office and supervisor(s);

- Regularly assess compliance with all applicable laws and regulations, as well as the bank's own internal policies;
- Ensure that these activities are within the scope of regular head office internal controls, as well as external audit reviews; and
- Appropriately disclose (e.g. in the annual report) information regarding the purpose, strategies, structures, volume, risks and controls around such activities.

IV. Ensuring an environment supportive of sound corporate governance

54. The Basel Committee recognises that primary responsibility for good corporate governance rests with boards of directors and senior management of banks. There are many others, however, that can promote good corporate governance, including:

- Shareholders – through the active and informed exercise of shareholder rights;
- Auditors – through a well-established and qualified audit profession, audit standards and communications to boards of directors, senior management and supervisors;
- Banking industry associations – through initiatives related to voluntary industry principles and agreement on and publication of sound practices;
- Governments – through laws, regulations, enforcement and an effective judicial framework;
- Banking supervisors – through issuance of guidance and assessment of corporate governance practices as described in section V;
- Securities regulators, stock exchanges and other self-regulatory organisations – through disclosure and listing requirements; and
- Employees – through communication of concerns regarding illegal or unethical practices or other corporate governance weaknesses;

55. As noted above, corporate governance can be improved by addressing a number of legal issues, such as protecting and promoting shareholder rights; clarifying governance roles; ensuring that corporations function in an environment that is free from corruption and bribery; and aligning the interests of managers, employees and shareholders through appropriate laws, regulations and other measures. 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

56. As a bank's board of directors and senior management are primarily responsible and accountable for the performance of the bank, supervisors should determine whether the bank has appropriate corporate governance policies and practices with which it is satisfactorily complying and bring to the board of directors' and management's attention problems that they detect through their supervisory efforts. Supervisors should play an important role in promoting strong corporate governance by reviewing and evaluating a bank's implementation of the sound principles set forth in section III above as key elements of the supervisory process. When the bank takes risks that it cannot measure or control, supervisors should hold the board of directors and senior management 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.

57. Supervisors should be aware of the importance of corporate governance and its impact on corporate performance. Poor corporate governance practices can be either a cause or a symptom of larger problems that merit supervisory attention. Supervisors should expect banks to implement organisational structures that include the appropriate checks and balances. Regulatory safeguards should emphasise accountability and transparency. Supervisors should obtain necessary information to determine that directors and senior managers individually and collectively have sufficient banking or other business experience, personal integrity, and relevant skills. Moreover, 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.

58. Supervisors should consider issuing guidance to banks on sound corporate governance and the pro-active practices that need to be in place. In so doing, supervisors should recognise that banks will need to adopt different approaches to corporate governance, taking into account the nature, scope, complexity and risk profile of the bank. The supervisory process should take this into consideration in evaluating bank corporate governance. Supervisors should also take account of corporate governance issues in issuing guidance on other topics. This is fundamental to a risk-based approach to supervising banks.

59. Supervisors should assess the quality of banks' internal controls. It is important that effective controls not only be set out in policy, but also be properly implemented and made operational. In this regard, supervisors should pay close attention to the effectiveness of oversight by a bank's board of directors and the adequacy of internal controls that are designed to detect and mitigate conflicts of interest. Supervisors should ensure that internal and external audit functions conduct independent and effective reviews of bank internal controls. Supervisors should assess whether the board and senior management are fulfilling their respective duties consistent with the guidance in this paper, and should promote transparency in bank corporate governance.

60. Supervisors also need to have the authority to obtain information on, and evaluate the effects on a bank of, the group structure to which it belongs. This information should include the fitness and propriety of the major shareholders and directors of the parent company and the adequacy of the arrangements in place at the parent company to ensure the effectiveness of the group's activities, including coordination of the same functions at the bank and group level. Supervisors should also ensure that there is appropriate internal reporting and communication to the parent board in respect of all material risk and other issues that may affect the group (e.g. group-wide "know-your-structure").

61. The licensing and supervisory processes also afford supervisors an important opportunity to evaluate the expertise and integrity of proposed directors and management. The fit and proper criteria typically include: (1) the contributions that such an individual's skills and experience are likely to make to the safe and sound operation of the bank, and (2) any record of criminal activities or adverse regulatory judgments that in the supervisor's judgment make a person unfit to uphold important positions in a bank.

62. Sound corporate governance considers the interests of all stakeholders, including depositors, in a balanced fashion. In determining that individual banks are conducting their business in such a way as not to harm depositors, supervisors may view corporate governance as one element of depositor protection. Depositors' interests should be considered in conjunction with depositor insurance schemes, the need to avoid "moral hazard" which may result from particular approaches to consumer protection, and other relevant principles, including the objective of encouraging financial innovation.