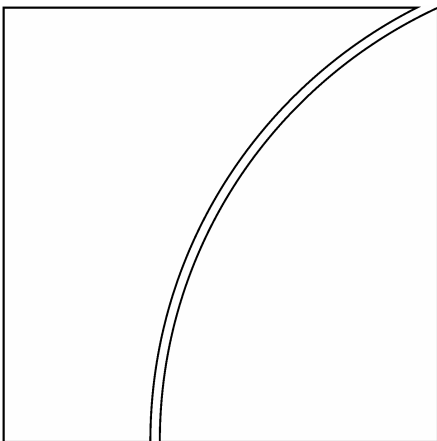


Basel Committee
on Banking Supervision



**Enhancing corporate
governance for
banking organisations**

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Enhancing Corporate Governance for Banking Organisations

I. Introduction

1. Given the important financial intermediation role of banks in an economy, their high degree of sensitivity to potential difficulties arising from ineffective corporate governance and the need to safeguard depositors' funds, corporate governance for banking organisations is of great importance to the international financial system and merits targeted supervisory guidance. The Basel Committee on Banking Supervision¹ (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.² This guidance drew from principles of corporate governance that were published earlier that year by the Organisation for Economic Co-operation and Development (OECD)³ 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.⁴

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 of banking organisations, the Committee is publishing this revision to its 1999 guidance. A revised version of the 1999 paper was released for public consultation in July 2005. This paper, which broadly retains the structure of the 1999 paper, takes into account comments received during the consultative period. This paper also presents some considerations for corporate governance related to the activities of banking organisations that are conducted through structures that may lack transparency, or in jurisdictions that pose impediments to information flows.

3. The Basel Committee is issuing this paper to supervisory authorities and banking organisations worldwide to help ensure the adoption and implementation of sound corporate governance practices by banking organisations. This guidance is not intended to establish a new regulatory framework layered on top of existing national legislation, regulation or codes,

¹ 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.

² See *Enhancing Corporate Governance for Banking Organisations*, Basel Committee on Banking Supervision, September 1999.

³ 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.

⁴ For reference, the OECD has set forth a glossary of corporate governance-related terms in *Experiences from the Regional Corporate Governance Roundtables*, 2003. Precise uses of these terms may vary, however, across jurisdictions.

but is rather intended to assist banking organisations in enhancing their corporate governance frameworks, and to assist supervisors in assessing the quality of those frameworks. The implementation of the principles set forth in this paper should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs. The application of corporate governance standards in any jurisdiction will depend on relevant laws, regulations, codes and supervisory expectations.

4. Sound practice papers issued by the Basel Committee in recent years highlight the principles described in this paper by describing the roles of the board of directors and senior management in managing risk and underscoring the need for banks to set strategies for their operations and establish accountability for executing these strategies. These sound practice papers have highlighted strategies and techniques for managing risk and include a number of common elements that are basic to sound corporate governance.

5. This paper reinforces the key elements of widely accepted and long-established corporate governance principles that guide the actions of the directors, managers and supervisors of a diverse range of banks⁵ in a number of countries with varying legal and regulatory 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, 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), as well as accounting and auditing standards, 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. 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).⁶ The principles set forth in this paper are applicable regardless of whether or not a country chooses to adopt the Basel II Framework. The Committee nevertheless recognised the importance of sound corporate governance when it published the Basel II Framework. In this regard, 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.

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. Some countries use a two-tier structure, where the supervisory function of the board of directors is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries, by contrast, use a

⁵ The terms “bank” and “banking organisation” as used in this document generally refer to banks, bank 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 application to banks or banking organisations, unless explicitly noted or otherwise indicated by the context.

⁶ See *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, Basel Committee on Banking Supervision, June 2004.

one-tier structure in which the board has a broader role. 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 collectively 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. Effective corporate governance practices 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. Poor corporate governance may contribute to bank failures, which can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. 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 bank run or liquidity crisis. Indeed, in addition to their responsibilities to shareholders, banks also have a responsibility to their depositors.

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 banks are governed by their boards of directors and senior management, which affects how they:

- Set corporate objectives;
- Operate the bank’s business on a day-to-day basis;
- Meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders;⁷
- 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. Supervisors have a keen interest in sound corporate governance as it is an essential element in the safe and sound functioning of a bank and may affect the bank’s risk profile if not implemented effectively. 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. Sound corporate governance also contributes to the protection of depositors of the bank and permits the supervisor to place more reliance on the bank’s internal processes. In this regard, supervisory experience underscores the importance of having the appropriate levels of

⁷ 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.

accountability and checks and balances within each bank. Moreover, sound corporate governance practices are especially important in situations where a bank is experiencing problems, or where significant corrective action is necessary, as the supervisor may require the board of directors' substantial involvement in seeking solutions and overseeing the implementation of corrective actions.

12. There are unique corporate governance challenges posed where bank ownership structures either lack transparency or where there are insufficient checks and balances on inappropriate activities or influences of insiders or 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 supervisors. 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.⁸

13. Good corporate governance requires appropriate and effective legal, regulatory and institutional foundations. A variety of factors, including the system of business laws and accounting standards, can affect market integrity and overall economic performance. Such factors, however, are often outside the scope of banking supervision.⁹ 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 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: (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.

15. Although government ownership of a bank has the potential to alter the strategies and objectives of the bank, a state-owned bank may face many of the same risks associated with weak corporate governance that are faced by banks that are not state-owned.¹⁰ Consequently, the general principles of sound corporate governance should also be applied to state-owned banks. Likewise, these principles apply to banks with other types of ownership structures, for example those that are family-owned or part of a wider non-financial group, and to those that are non-listed.

⁸ 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.

⁹ 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.

¹⁰ Further guidance for the state in exercising its ownership function may be found in the *OECD Guidelines on Corporate Governance of State-owned Enterprises*, October 2005.

III. Sound corporate governance principles

16. As discussed above, supervisors have a keen interest in ensuring that banks adopt and implement sound corporate governance practices. The following discussion draws on supervisory experience with corporate governance problems at banking organisations and is therefore designed to reinforce principles that could help to minimise such problems. These principles are viewed as important elements of an effective corporate governance process.

Principle 1

Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.

17. The board of directors is ultimately responsible for the operations and financial soundness of the bank. While not intended to be a “checklist” of requirements, the Committee has observed that boards of directors and their individual members strengthen the corporate governance of a bank when they do the following:

- Understand and execute their oversight role, including understanding the bank’s risk profile;
- Approve the overall business strategy of the bank, including approval of the overall risk policy and risk management procedures;
- Exercise their “duty of loyalty” and “duty of care” to the bank under applicable national laws and supervisory standards;
- 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 a conflict of interest that makes them incapable of properly fulfilling their duties to the bank;
- Commit sufficient time and energy to fulfilling their responsibilities;
- Structure themselves (as a board) in a way, including size, that promotes efficiency and real strategic discussion;
- Develop and maintain an appropriate level of 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 and management of conflicts of interest, 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;
- Provide oversight of 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 review 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 advice and recommend sound practices gleaned from other situations;
- Avoid participation as the board of directors in day-to-day management of the bank;¹¹ 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).

18. Banks should have an adequate number and appropriate composition of directors who are capable of exercising judgment independent of the views of management, political interests or inappropriate outside interests.¹² In addition, the board of directors has a responsibility to protect the bank from illegal or inappropriate actions or influences of dominant or controlling shareholders that are detrimental to, or not in the best interest of, the bank and its shareholders. Independence and objectivity can be enhanced by including qualified non-executive directors on the board or by having a supervisory board or board of auditors separate from a management board. 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.

19. The board should have adequate collective knowledge of each of the types of material financial activities the bank intends to pursue. In addition, the board should have sufficient knowledge and expertise to enable effective governance and oversight. In some cases, however, bank directors who are not engaged in management functions may not have detailed knowledge of banking, finance, risk management, regulatory compliance, information and communication technology or other related topics. Where otherwise qualified individuals lack such knowledge, banks are encouraged to implement programs of ongoing education for board members, or take other steps to ensure that such knowledge is available to the board, in order to better enable them to fulfil their responsibilities.

20. Controlling shareholders 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 responsibilities to the bank itself. 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 continue to have responsibilities independent of political influence which could lead to conflicts of interest (e.g. when directors

¹¹ This does not apply to members of the board of directors who are also employees of the bank (e.g. senior managers).

¹² 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 sound judgment after fair consideration of all relevant information and views without undue influence from management or inappropriate outside interests. 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.

are state officials, as is often the case in practice, or have explicit political interests). This does not deny the right of the state as owner, however, to set overall objectives for the bank.

21. In a number of countries, especially those with a single board combining oversight and management functions, 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 (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.

22. The Committee believes that it is appropriate and beneficial for large, internationally active banks to have an *audit committee* or equivalent structure responsible for similar functions. The audit committee typically is responsible for providing oversight of the bank's internal and external auditors; approving, or recommending to the board of directors or shareholders for their approval, the appointment,¹³ compensation and dismissal of external auditors; 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.

23. To achieve sufficient objectivity and independence, the audit committee should be comprised, at a minimum, of a majority of board members who are independent and who have a firm understanding of the role of the audit committee in the bank's risk management and governance. The audit committee often consists solely of non-executive directors. Where executives normally attend audit committee meetings, 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 audit committee as a whole should have recent and relevant experience and should possess a collective balance of skills and expert knowledge - commensurate with the complexity of the banking organisation and duties performed - in financial reporting, accounting or auditing.

24. 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, compliance, reputational and other risks of the bank.
- *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/human resources committee* – providing assessment of board effectiveness and directing the process of renewing and replacing board members.

¹³ In some jurisdictions, external auditors are appointed directly by shareholders, with the board only making a recommendation.

Non-executive directors, as well as directors with relevant skills and knowledge, may play a key role on such board committees.

Principle 2

The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation.

25. It is difficult to conduct the activities of an organisation when there are no strategic objectives or guiding corporate values.¹⁴ Therefore, the board should establish the strategic objectives and high standards of professional conduct that will direct the ongoing activities of the bank, taking into account the interests of shareholders and depositors, and should take steps to ensure that these objectives and standards are widely communicated within the organisation. A demonstrated corporate culture that mandates and provides appropriate incentives for professional behaviour is as important as, if not more important than, any written set of values and high professional standards. In this regard, the board should take the lead in establishing the “tone at the top” and approving professional standards and corporate values for itself, senior management and other employees. The consistent practice of high professional 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, self-dealing and any other illegal, unethical or questionable behaviour in banks' internal and external activities.

26. The board of directors should 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, relationships or situations that might diminish the quality of corporate governance, such as:

- Conflicts of interest (as discussed below).
- Lending to officers, employees, directors or controlling shareholders (i.e. where allowed by national law). Where internal lending occurs, it should be consistent with bank safety and soundness. For example, it may be limited to lending consistent with market terms or terms offered to all employees¹⁵ as a routine part of their remuneration and may be restricted to certain types of loans. Reports of insider lending should be provided to the board,¹⁶ and such lending should be subject to review by internal and external auditors and supervisors.
- Providing preferential treatment to related parties and other favoured entities (e.g. lending on favourable terms, covering trading losses, waiving commissions).

27. Conflicts of interest may arise as a result of the various activities and roles of the bank (e.g. where the bank extends loans to a firm while its proprietary trading function buys and sells securities issued by that firm), or between the interests of the bank or its customers and those of the bank's directors or senior managers (e.g. where the bank enters into a

¹⁴ 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.

¹⁵ This does not preclude the possibility that banks might apply risk-based pricing techniques to such lending to employees.

¹⁶ Reports of routine lending to employees may be provided, for example, on an aggregate basis or based on materiality criteria approved by the supervisor.

business relationship with an entity owned by one of the bank's directors). 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). The board of directors should ensure that senior management develops and implements policies to identify potential conflicts of interest and, if these conflicts cannot be prevented, to appropriately manage them (based on the permissibility of relationships or transactions under sound corporate policies consistent with national law and supervisory standards).

28. The board of directors' 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 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. These policies should also ensure through adequate procedures that transactions with related parties, in particular with shareholders, executive officers or members of the board and other related companies, are made on an arms-length basis (unless allowable under an appropriate and disclosed conflicts-of-interest policy) and are not made on terms contrary to the interest of the bank, its shareholders and depositors. In jurisdictions that provide for consolidated supervision of a regulated parent company, these issues are typically addressed through law, regulation and/or the supervisory program.

29. The board of directors should ensure the appropriate public disclosure and/or inform supervisors of the bank's policies related to conflicts of interest and potential conflicts of interest. This should include the bank's approach to managing material conflicts of interest that are not consistent with such policies. This should also include the bank's policies related to conflicts of interest and potential conflicts of interest that may arise as a result of the bank's affiliation or transactions with other entities within the group, as well as the bank's approach to managing material conflicts of interest not falling within such policies. Similarly, the bank should disclose and/or report to supervisors material conflicts of interest not consistent with such policies.

30. 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.

31. The bank's corporate values should recognise the critical importance of timely and frank discussion of problems. In this regard, employees should be encouraged and able to communicate, with adequate corporate protection from reprisal, legitimate concerns about illegal, unethical or questionable practices. Because such practices can have a detrimental impact on a bank's reputation, it may prove highly beneficial for banks to establish a policy setting forth adequate procedures, consistent with national law, for employees to communicate material and bona fide concerns directly or indirectly (e.g. through an independent audit or compliance process or through an ombudsman) and confidentially to the board independent of the internal "chain of command." The board and senior management should, in turn, address such legitimate communications. Any process for reporting material concerns should include mechanisms to protect employee confidentiality. 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.

Principle 3

The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.

32. 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 duties 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.

33. 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. In reviewing corporate governance in the context of a group structure, supervisors should take into account the corporate governance responsibilities of both the bank and its parent. 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. The group dimension presents a particular regulatory challenge where a bank is experiencing problems or where significant corrective action is necessary; in these situations the supervisor may require substantial and meaningful involvement of the bank's board in seeking solutions and implementation of corrective actions.

34. In the discharge of their corporate governance responsibilities, parent boards should be aware of the material risks and issues that might affect the 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.

35. The group dimension also gives rise to a number of challenges for the bank as well as its supervisors.¹⁷ 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.¹⁸ The Committee has

¹⁷ 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.

¹⁸ When a bank is part of a non-financial group, it is especially important that the bank's governance framework recognise and fulfil the responsibility that the bank be operated in a safe and sound manner. Where transactions between the bank and other parts of the group are conducted, these transactions should be

noticed an increasing trend of parent-level matrix and business line management structures that may not coincide with the bank's legal structure (e.g. where employees have dual reporting lines to both business line and legal entity management). While such structures may be effective and may serve important business and control purposes of the overall organisation, such structures can nevertheless pose challenges to the effective corporate governance of the bank if they result in gaps in responsibility and accountability for operating subsidiaries. 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 proper fulfilment of corporate governance responsibilities at the bank and group level.

36. In addition, where a bank outsources key functions, the accountability of the directors and senior management of the bank cannot be delegated to the entities providing the outsourced services.¹⁹ 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 maintaining adequate oversight functions (without undue replication of functions at the group and bank level), nor does it eliminate the bank board's responsibility for understanding and managing the risks in the bank.

Principle 4

The board should ensure that there is appropriate oversight by senior management consistent with board policy.

37. Senior management consists of a core group of individuals, including, for example, the chief financial officer and division heads, who are responsible for overseeing the day-to-day management of the bank. 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.

38. 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 senior management is the establishment, under the guidance of the board of directors, of an effective system of internal controls.²⁰ 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; or
- Unwilling or unable to exercise effective control over the activities of apparent "star" employees. This is especially problematic where managers fail to question

consistent with prudent board policy, transparent and at an arm's length basis. Low-quality transactions with other group entities (e.g., where the current sound worth and paying capacity of the counterparty is in question), or transactions for which the purpose is not clear, should not be undertaken. The bank should to the extent feasible operate as a separate, stand-alone entity within the non-financial group.

¹⁹ See *Outsourcing in Financial Services*, The Joint Forum, February 2005.

²⁰ See *Framework for Internal Control Systems in Banking Organisations*, Basel Committee on Banking Supervision, September 1998.

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.

Principle 5

The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.

39. The board should recognise and acknowledge that independent, competent and qualified auditors, as well as internal control functions (including the compliance and legal functions), are vital to the corporate governance process in order to achieve a number of important objectives. In particular, the board should utilise the work of the auditors and the control functions to provide an independent check and assurance 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 and control functions to the long-term soundness of the bank.

40. The board and senior management can enhance the effectiveness of the internal audit function²¹ in identifying problems with a company's risk management and internal control systems by:

- Recognising the importance of the audit and internal control processes and communicating their importance throughout the bank;
- Utilising, in a timely and effective manner, the findings of internal audits and requiring timely correction of problems by management;
- Promoting the independence of the internal auditor, for example through reporting to the board or the board's audit committee; and
- Engaging internal auditors to judge the effectiveness of key internal controls.

41. The board and senior management can contribute to the effectiveness of external auditors²² in order to ensure that the bank's financial statements fairly represent the financial position and performance of the company in all material respects by:

- Ensuring that external auditors are in compliance with applicable codes and standards of professional practice;²³
- Encouraging, consistent with national standards, the principal auditor²⁴ to take responsibility for other external audits of financial statements conducted within a group and its global operations, so as to minimise the risk of gaps in the scope or conduct of audit activities and ensure the integrity of financial statements;

²¹ See *Internal audit in banks and the supervisor's relationship with auditors*, Basel Committee on Banking Supervision, August 2001.

²² See *The relationship between banking supervisors and banks' external auditors*, Basel Committee on Banking Supervision, January 2002.

²³ For example, the International Federation of Accountants' *Code of Ethics for Professional Accountants*.

²⁴ The principal auditor, who is responsible for expressing an audit opinion on the group financial statements, may use the work of other auditors. If the principal auditor is unable to obtain sufficient appropriate audit evidence in relation to any components of the group, the principal auditor will need to consider the effect of a scope limitation on its audit opinion on the group financial statements.

- Engaging external auditors to review the internal control processes related to disclosure of financial statements;
- Ensuring that external auditors understand their duty to the bank to exercise due professional care in the conduct of audits;
- Considering periodic rotation, at a minimum, of the lead audit partner; and
- For state-owned banks, maintaining a dialogue as appropriate with state supreme audit institutions responsible for auditing the bank, as well as state controllers (where these exist) and external auditors, as appropriate.

42. The bank should maintain sound internal control functions, including an effective compliance function that, among other things, routinely monitors compliance with corporate governance rules, regulations, codes 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.²⁵

43. 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 comprising a majority of independent members. 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.

Principle 6

The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.

44. 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.

45. The board of directors or the designated board committee should determine or approve, consistent with any adopted remuneration policy, the compensation of members of the board and senior management, and should ensure that such compensation is consistent with the bank's culture, long-term objectives and strategy, and control environment. 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.

46. 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,

²⁵ See *Compliance and the compliance function in banks*, Basel Committee on Banking Supervision, April 2005. This paper notes that the expression "compliance function" is used to describe staff carrying out employee responsibilities and is not intended to prescribe a particular organisational structure.

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 unduly related to the short-term performance of the bank.

47. Where executive directors or senior managers 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 or affiliated companies in which the bank has a material financial interest, as well as procedures to be followed in granting and re-pricing of options where these are a material component of overall compensation.

Principle 7

The bank should be governed in a transparent manner.

48. Transparency is essential for sound and effective corporate governance. As set out in existing Basel Committee guidance on bank transparency,²⁶ 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 ownership structure and objectives of the bank with which to judge the effectiveness of the board and senior management in governing the bank.

49. Appropriate public disclosure facilitates market discipline and thereby sound corporate governance, while reporting to supervisors enhances the ability of supervisors to more effectively monitor the safety and soundness of such banks. Although market discipline may be less relevant for non-listed banks, especially those that are wholly owned, non-listed 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 and reporting on aspects of corporate governance, consistent with national law and supervisory practice, can assist market participants and other stakeholders in monitoring the safety and soundness of the bank.

50. Timely and accurate public disclosure related to the following topics is desirable on a bank's public website, in its annual and periodic reports, in reports to supervisors or by other appropriate forms.²⁷ Disclosure should be proportionate to the size, complexity, ownership structure, economic significance and risk profile of the bank, as well as whether the bank is publicly traded or non-listed. The following is not a comprehensive list of all types of information that should be disclosed or reported (e.g. supervisors may also require disclosure or reporting of information regarding financial data, risk exposures, compliance and internal audit issues, etc), but rather represents information related more specifically to the governance of the bank:

²⁶ See *Enhancing Bank Transparency*, Basel Committee on Banking Supervision, September 1998.

²⁷ This discussion of transparency is not intended to create a new disclosure regime comparable to those set forth in national or international accounting standards, and should be viewed as complementary to the specific disclosures required for banks that adopt the Basel II capital framework.

- Board structure (e.g. bylaws, size, membership, selection process, qualifications, other directorships, criteria for independence, material interests in transactions or matters affecting the bank, and committee membership, charters and responsibilities) and senior management structure (e.g. responsibilities, reporting lines, qualifications and experience);
- Basic ownership structure (e.g. major share ownership and voting rights, beneficial owners,²⁸ major shareholder participation on the board or in senior management positions, shareholder meetings);
- Organisational structure (e.g. general organisational chart, business lines, subsidiaries and affiliates, management committees);
- Information about the incentive structure of the bank (e.g. remuneration policies, director and 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, an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of the bank, and how it will implement its ownership policy; and
- As discussed above, the bank's policies related to conflicts of interest, as well as the nature and extent of transactions with affiliates and related parties (which may be in aggregate form for routine lending to employees), 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.²⁹

51. While this section is not focused on financial disclosure, it should be noted that the full (annual) financial statement, with supporting notes and schedules, should be available to depositors and other customers (e.g. on the bank's website, in bank premises or in reports to supervisors where such reports are available to the public) in order to provide them with a clear and comprehensive picture of the financial standing of the bank and enable them to exercise market discipline.³⁰

²⁸ 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.

²⁹ 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*.

³⁰ In some jurisdictions, banks are required to provide only partial or abridged financial statements. 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.

Principle 8

The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure").

52. Corporate governance challenges arise where banks operate through structures that lack or impair transparency. Banks may choose to operate in a particular jurisdiction³¹ 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, a bank's senior management should ensure that such structures or activities comply with relevant laws and regulations. The board of directors should also consider the appropriateness, of and set suitable limits on, operations in such jurisdictions or the use of such structures, and should ensure that senior management establishes policies for the identification and management of the full range of risks associated with such structures or activities. The board of directors, or senior management under the direction of the board, should document this process of consideration, authorisation and risk management to make this process transparent to auditors and supervisors.

53. 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.³² 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 inappropriate activities. This can, in turn, pose significant legal and reputational risks to banks that provide such services. Banks that engage in such activities should therefore have policies and procedures in place to identify and manage all material risks arising from such activities.

54. 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 oversee 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 establish an appropriate policy and process to evaluate the bank's use and/or sale of these structures,

³¹ 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.

³² See *Customer due diligence for banks*, Basel Committee on Banking Supervision, October 2001.

instruments or products periodically as part of its regular review of management. Banks should only approve complex financial structures, instruments or products if the material financial, legal and reputational risks arising from their use or sale can be properly assessed and managed.

55. 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 internal auditors, 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. The frequency of these reviews should be based on an assessment of risk, and management should ensure that the board is notified of the existence and management of any significant risks that are identified.

56. While the board of directors is responsible for overall oversight and approval of policies, and senior management is 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 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 ensure the bank has appropriate policies and procedures to:

- Regularly evaluate the need to operate in jurisdictions or through complex structures that reduce transparency;
- Identify, measure and manage all material risks, including legal and reputational risks, arising from such activities;
- Establish appropriate processes 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 and business lines 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;
- Oversee the regular assessment of 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
- Ensure that information regarding these activities and associated risks is readily available to the bank’s head office, is appropriately reported to the board of directors and supervisors, including adequate information regarding the purpose, strategies, structures, volume, risks and controls around such activities, and is appropriately disclosed to the public.

IV. The role of supervisors

57. A bank's board of directors and senior management are primarily responsible and accountable for the performance of the bank. Likewise, shareholders should hold the board accountable for governing the bank effectively. A key role of supervisors is then to promote strong corporate governance by reviewing and evaluating a bank's implementation of the sound principles set forth in section III above. This section therefore sets forth several principles that can assist supervisors in assessing bank corporate governance.

Supervisors should provide guidance to banks on sound corporate governance and the pro-active practices that should be in place.

58. In developing guidance, supervisors should recognise that banks will need to adopt different approaches to corporate governance that are proportional to the size, complexity, structure and risk profile of the bank. The supervisory process should take this into consideration in evaluating bank corporate governance.

Supervisors should consider corporate governance as one element of depositor protection.

59. Sound corporate governance considers not only the interests of shareholders, but also the interests of depositors. Supervisors should determine that individual banks are conducting their business in such a way as to not be detrimental to the interests of depositors. Therefore, depositors' interests should be considered in conjunction with any applicable deposit insurance systems, the need to avoid "moral hazard" which may result from particular approaches to consumer protection, and other relevant principles.

Supervisors should determine whether the bank has adopted and effectively implemented sound corporate governance policies and practices.

60. An important element of supervisory oversight of bank safety and soundness is an understanding of how corporate governance affects a bank's risk profile. Supervisors should not only evaluate corporate governance policies and procedures, but also evaluate banks' implementation of these policies and procedures. Supervisors should expect banks to implement organisational structures that include the appropriate checks and balances. Regulatory guidance should emphasise accountability and transparency.

61. Supervisors, as well as licensing authorities, should obtain necessary information to evaluate the expertise and integrity of proposed directors and management. The fit and proper criteria should include, but may not be limited to: (1) the contributions that 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. Moreover, supervisors should determine that the boards and senior management of individual institutions have in place processes to review the fulfilment of their duties and responsibilities. It may be helpful in this regard for supervisors to meet with individual directors and senior managers as part of the ongoing supervisory process.

Supervisors should assess the quality of banks' audit and control functions.

62. Supervisors should evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their oversight responsibilities. Such mechanisms include internal and external audit, risk management and compliance functions. In this regard, supervisors should assess the effectiveness of oversight of these functions by a bank's board of directors. This could include (with the consent of senior management, if necessary) meetings with internal and external auditors as well as senior risk managers, compliance officers, and other key personnel in control functions. Supervisors should ensure that the internal audit function conducts independent, comprehensive and effective reviews of bank risk management and internal controls. Supervisors should assess the adequacy of internal controls that foster effective governance. It is important that effective internal controls not only be well-defined in policies and procedures, but also that they be properly implemented.

Supervisors should evaluate the effects of the bank's group structure.

63. Supervisors should be able to obtain information regarding the structure of the group to which a bank belongs. For example, management should, upon request by supervisors, be able to provide a full list of all group entities affiliated with the bank, as well as business lines of the group. Information about the group structure should allow for an assessment of the fitness and propriety of the major shareholders and directors of the parent company and the adequacy of the oversight process within the group, including coordination of the same functions at the bank and group level. Supervisors should also ensure that there is appropriate internal reporting and communication from the bank to the parent board, and vice versa, in respect of all material risk and other issues that may affect the group (e.g. group-wide "know-your-structure"). Where a bank or the group to which it belongs are internationally active, banking supervisors should cooperate and share information with other supervisors to enhance supervisory effectiveness and reduce supervisory burden.³³ Where banks operate in jurisdictions, or through structures, that impede transparency, countries should work to adopt laws and regulations enabling bank supervisors to obtain and review the documentation of a bank's analysis and authorisation process and to take appropriate supervisory action to address deficiencies and inappropriate activities when necessary.

Supervisors should bring to the board of directors' and management's attention problems that they detect through their supervisory efforts.

64. Poor corporate governance practices can be either a cause or a symptom of larger problems that merit supervisory attention. Supervisors should be attentive to any warning signs of deterioration in the management of the bank's activities. When supervisors believe that the bank has taken risks that it is unable to fully measure or control, they should hold the board of directors and senior management accountable and require that corrective measures be taken in a timely manner.

³³ This is consistent with *Principles for the supervision of banks' foreign establishments* (also known as the Basel Concordat), Basel Committee on Banking Supervision, May 1983, and subsequent Basel Committee papers on supervisory cooperation and home-host supervision.

V. Promoting an environment supportive of sound corporate governance

65. The Basel Committee recognises that primary responsibility for good corporate governance rests with boards of directors and senior management of banks. In addition, as discussed in section IV, banking supervisors have an important role in developing guidance and assessing bank corporate governance practices. There are many others, however, that can promote good corporate governance, including:

- Shareholders – through the active and informed exercise of shareholder rights;
- Depositors and other customers – by not conducting business with banks that are operated in an unsound manner;
- 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;
- Professional risk advisory firms and consultancies – through assisting banks in implementing sound corporate governance practices;
- Governments – through laws, regulations, enforcement and an effective judicial framework;
- Credit rating agencies – through review and assessment of the impact of corporate governance practices on a bank's risk profile;
- 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.

66. 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 of corporate bodies;
- Ensuring that corporations function in an environment that is free from corruption and bribery; and
- Promoting the alignment of 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.

67. The Committee recognises that some countries may face special challenges in enhancing corporate governance. The basic framework and mechanisms for corporate governance which have evolved in developed economies such as an effective legal framework and supervisory process, independent judiciary and efficient capital markets may be weak or missing in many transition economies. Enhancements to the framework and mechanisms for corporate governance should be driven by such benefits as improved operational efficiency, greater access to funding at a lower cost, and an improved reputation. These enhancements will likely evolve over time as countries move at differing paces from a

level of minimum compliance with regulatory requirements to increasing commitment to sound governance.