Basel Committee
on Banking Supervision

Consultative Document

Principles for enhancing corporate governance

Issued for comment by 15 June 2010

March 2010

BANK FOR INTERNATIONAL SETTLEMENTS

Copies of publications are available from:

Bank for International Settlements
Communications
CH-4002 Basel, Switzerland

E-mail: publications@bis.org

Fax: +41 61 280 9100 and +41 61 280 8100

This publication is available on the BIS website (www.bis.org).

ISBN 92-9131-818-3 (print)

ISBN 92-9197-818-3 (online)

Contents

Working Group on Corporate Governance of the Basel Committee on Banking Supervision

Chairwoman: Mme Danièle Nouy, French Banking Commission

Banking, Finance and Insurance Commission, Belgium	Mr Hein Lannoy
China Banking Regulatory Commission	Mr Liao Min
French Banking Commission	Mr Jean-Christophe Cabotte Mr Fabrice Macé
Deutsche Bundesbank, Germany	Ms Kathrin Schulte-Südhoff
Federal Financial Supervisory Authority (BaFin), Germany	Ms Heike Berger-Kerkhoff
Bank of Italy	Ms Diana Capone
Bank of Japan	Mr Jun Iwasaki
Financial Services Agency, Japan	Mr Hideaki Kamei
Surveillance Commission for the Financial Sector, Luxembourg	Ms Nadia Manzari
Netherlands Bank	Ms Annick Teubner
Central Bank of the Russian Federation	Mr Oleg Letyagin
Saudi Arabian Monetary Agency	Mr Abdullah Alsoyan
Bank of Spain	Mr Francisco Ovelar
Finansinspektionen, Sweden	Ms Cecilia Wennerholm
Swiss Financial Market Supervisory Authority	Mr Gabe Shawn Varges
Financial Services Authority, United Kingdom	Mr Chris Hibben
Federal Deposit Insurance Corporation, United States	Ms Melinda West
Federal Reserve Bank of New York, United States	Ms Kristin Malcarney
Board of Governors of the Federal Reserve System, United States	Mr Kirk Odegard
Office of the Comptroller of the Currency, United States	Ms Karen Kwilosz
European Commission	Mr Elies Messaoudi
Organisation for Economic Co-operation and Development	Mr Grant Kirkpatrick
World Bank	Ms Laura Ard Ms Katia D'Hulster
Financial Stability Institute	Mr Denis Sicotte
Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements	Mr Toshio Tsuiki

Principles for Enhancing Corporate Governance

I. Introduction

1. Given the important financial intermediation role of banks in an economy, the public and the market have a high degree of sensitivity to any difficulties potentially arising from any corporate governance shortcomings in banks. Corporate governance is thus of great relevance both to individual banking organisations and to the international financial system as a whole, and merits targeted supervisory guidance.

2. The Basel Committee on Banking Supervision[1] (the Committee) has had a longstanding commitment to promoting sound corporate governance practices for banking organisations. It published initial guidance in 1999, with revised principles in 2006.[2] The Committee's guidance assists banking supervisors and provides a reference point for promoting the adoption of sound corporate governance practices by banking organisations in their countries. The principles also serve as a reference point for the banks' own corporate governance efforts.

3. The Committee's 2006 guidance drew from principles of corporate governance that were published in 2004 by the Organisation for Economic Co-operation and Development (OECD).[3] The OECD's widely accepted and long-established principles aim to assist governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for participants and regulators of financial markets.[4]

4. The Committee's 2006 principles targeted key issues of corporate governance. Among the primary points in the 2006 guidance were that:

- the board should be appropriately involved in approving the bank's strategy;
- clear lines of responsibility should be set and enforced throughout the organisation;
- compensation policies should be consistent with the bank's long-term objectives; and
- the risks generated by operations that lack transparency should be adequately managed.

---

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 Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the 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 and February 2006, available at www.bis.org/publ/bcbs122.htm.

3 See *OECD Principles of Corporate Governance*, revised April 2004, originally issued June 1999, available at www.oecd.org/dataoecd/32/18/31557724.pdf. The OECD principles constitute one of the twelve key standards of the Financial Stability Board 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, which can be accessed at www.oecd.org/dataoecd/19/26/23742340.pdf. Precise uses of these terms may vary, however, across jurisdictions.

5. Subsequent to the publication of the Committee's 2006 guidance, there have been a number of corporate governance failures and lapses, many of which came to light during the financial crisis that began in mid-2007.[5] These included, for example, insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank organisational structures and activities. Against this background, the Committee decided to revisit its 2006 principles. Having reviewed and revised these principles, the Committee reaffirms their continued relevance and the critical importance of their adoption by banks and supervisors to ensure effective implementation of the principles.[6] The key areas where the Committee believes the greatest focus is necessary are highlighted below:

(1) Board practices

- The board should actively carry out its overall responsibility for the bank, including its business and risk strategy, organisation, financial soundness and governance. The board should also provide effective oversight of senior management.
- To fulfil this responsibility, the board should:
  - exercise sound objective judgment and have and maintain appropriate qualifications and competence, individually and collectively;
  - follow good governance practices for its own work as a board; and
  - be supported by competent, robust and independent risk and control functions, for which the board provides effective oversight.

(2) Senior management

- Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite[7] and policies approved by the board.

(3) Risk management and internal controls

- A bank should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board;

---

[5] Many of these shortcomings at major global financial services firms were highlighted in the Senior Supervisors Group report on *Observations on Risk Management Practices during the Recent Market Turbulence,* March 2008, available at www.newyorkfed.org/newsevents/news/banking/2008/rp080306.html and its subsequent report on *Risk Management Lessons from the Global Banking Crisis of 2008,* October 2009, available at www.newyorkfed.org/newsevents/news/banking/2009/ma091021.html.

[6] The OECD has supplemented its principles to take account of the experience of the financial crisis. See *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles, 2010,* available at www.oecd.org/dataoecd/53/62/44679170.pdf.

[7] Some banks and supervisors use the term "risk tolerance" to describe the amount of risk the bank is willing to accept. Other banks and supervisors use the term "risk appetite" to create a distinction between the absolute risks which a bank *a priori* is open to take (risk appetite) versus the actual limits within the risk appetite which the bank pursues (risk tolerance). Risk appetite can imply a more forward-looking or wider view of acceptable risks, whereas risk tolerance suggests a more immediate definition of the specific risks that banks will take. Since there does not appear to be consensus among supervisors or banks in this regard, "risk tolerance/appetite" is used in this document.

- Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the banks' risk profile (including its growth) and to the external risk landscape; and
- Effective risk management requires frank and timely internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

(4) Compensation

- The banks should fully implement the Financial Stability Board's (FSB - formerly the Financial Stability Forum) *Principles for Sound Compensation Practices* (FSB Principles) and accompanying *Implementation Standards*[8] (FSB Standards) or the applicable national provisions that are consistent with the FSB Principles and Standards.

(5) Complex or opaque corporate structures

- The board and senior management should know, understand and guide the bank's overall corporate structure and its evolution, ensuring that the structure (and the entities that form the structure) is justified and does not involve undue or inappropriate complexity; and
- Senior management, and the board as appropriate, should understand the purpose of any structures that impede transparency, be aware of the special risks that such structures may pose and seek to mitigate the risks identified.

(6) Disclosure and transparency

- Transparency is one tool to help emphasise and implement the main principles for good corporate governance.

6. This guidance is intended to assist banking organisations[9] in enhancing their corporate governance frameworks and to assist supervisors in assessing the quality of those frameworks. It is not, however, intended to establish a new regulatory framework layered on top of existing national legislation, regulation or codes. The implementation of the principles set forth in this document 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 is naturally expected to be pursued in a manner consistent with applicable national laws, regulations and codes. The Committee recognises that some countries have found it appropriate to adopt legal frameworks and standards (eg for publicly traded firms), as well as accounting and auditing standards, which may be more extensive and prescriptive than the principles set forth in this

---

[8] See *FSF Principles for Sound Compensation Practices,* April 2009, available at www.financialstabilityboard.org/publications/r_0904b.pdf, and *Implementation Standards,* September 2009, available at www.financialstabilityboard.org/publications/r_090925c.pdf.

[9] 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 document makes no distinction in application to banks or banking organisations, unless explicitly noted or otherwise indicated by the context.

document. Such frameworks and standards tend to be particularly relevant for larger or publicly traded banks or financial institutions. Whatever the case may be, supervisors are encouraged to periodically check their frameworks and standards for consistency with relevant Committee guidance.

7. Many of the corporate governance shortcomings identified during the financial crisis that began in mid-2007 have been observed not only in the banking sector but also in the insurance sector. As such, the Committee has coordinated its review with the International Association of Insurance Supervisors (IAIS). The IAIS is currently developing a set of principles for corporate governance focusing on the insurance industry. The Committee and IAIS seek to collaborate on monitoring the sound implementation of their respective principles.

8. This document reinforces the key elements of the aforementioned OECD corporate governance principles and is intended to guide the actions of board members, senior managers and supervisors of a diverse range of banks in a number of countries with varying legal and regulatory systems, including both Committee-member countries and non-member countries. While one fundamental corporate governance issue in respect of publicly listed companies is effective shareholder rights, such rights are not the primary focus of this guidance and are instead addressed in the OECD principles.

9. The principles set forth in this document are applicable regardless of whether or not a country chooses to adopt the Basel II framework.[10] The Committee nevertheless recognised the importance of sound corporate governance when it published the Basel II framework. In this regard, the board and senior management at each institution have an obligation to pursue good governance, in addition to understanding the risk profile of their institution.

10. This document refers to a governance structure composed of a board and senior management. The Committee recognises that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions. Some countries use a two-tier structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries, by contrast, use a one-tier structure in which the board has a broader role. Owing to these differences, the terms board and senior management are used in this document not to identify legal constructs, but rather as a way to refer to the oversight function and the management function, depending on which tasks are assigned to the different functions by the applicable law within each jurisdiction. Recognising that different structural approaches to corporate governance exist across countries, this document encourages practices that can strengthen checks and balances and sound corporate governance under diverse structures.

II. Overview of bank corporate governance

11. 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

[10] In July 2009, in an effort to address the fundamental weaknesses in banks' governance and risk management practices, the Committee enhanced the Basel II framework, including strengthened standards of Pillar 2, the supervisory review process. See *Enhancements to the Basel II Framework*, Basel Committee on Banking Supervision, July 2009, available at www.bis.org/publ/bcbs157.htm.

of the banking sector and economy as a whole. Poor corporate governance can contribute to bank failures, which can in turn pose significant public costs and consequences due to their potential impact on any applicable deposit insurance system and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. This has been illustrated in the financial crisis that began in mid-2007. 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 and to other recognised stakeholders. The legal system in a country determines which responsibilities a bank may have to its shareholders, depositors and other relevant stakeholders. This document will use the phrase "shareholders, depositors and other relevant stakeholders," while recognising that banks' responsibilities in this regard vary across jurisdictions.[11]

12. 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 or group 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."

13. From a banking industry perspective, corporate governance involves the manner in which the business and affairs of a bank are governed by its board and senior management, including how they:

- set the bank's strategy and objectives;
- determine the bank's risk tolerance/appetite;
- operate the bank's business on a day-to-day basis;
- protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders; and
- align corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.

14. 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 adversely affect the bank's risk profile if not implemented effectively. Well-governed banks contribute to the maintenance of an efficient and cost-effective supervisory system. Sound corporate governance also contributes to the protection of depositors and may permit 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 accountability and checks and balances within each bank. Moreover, sound corporate governance practices can be helpful where a bank is experiencing problems, as the supervisor may require substantial involvement by the

[11] Supervisors, governments, bond holders 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.

bank's board or control functions in seeking solutions and overseeing the implementation of corrective actions.

15. There are unique corporate governance challenges posed where bank ownership structures are unduly complex, lack transparency, or impede sufficient checks and balances. Challenges can also arise when insiders or controlling shareholders exercise inappropriate influences on the bank's activities. The Committee is not suggesting that the existence of controlling shareholders is in and of itself inappropriate; in many markets and for many small banks this is a common ownership pattern. Indeed, controlling shareholders can be beneficial resources for a bank. 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 as well as board members and senior managers.[12]

16. Good corporate governance requires appropriate and effective legal, regulatory and institutional foundations. A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability. Such factors, however, are often outside the scope of banking supervision.[13] 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. Where it is not, supervisors may wish to consider supporting legislative or other reforms that would allow them to have a more direct role in promoting or requiring good corporate governance.

17. 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. The important forms of oversight that should be included in the organisational structure of any bank in order to ensure appropriate checks and balances include oversight by the board; oversight by senior management; direct line supervision of different business areas; and independent risk management, compliance and audit functions.

18. The general principles of sound corporate governance should also be applied to state-owned or state-supported banks, including when such support is temporary (eg during the financial crisis that began in mid-2007, national governments and/or central banks in some cases provided capital support to banks). In these cases, government financing or ownership (even if temporary) may raise new governance challenges. Although government financing or ownership of a bank has the potential to alter the strategies and objectives of the bank, such a bank may face many of the same risks associated with weak corporate governance as are faced by banks that are not state-owned or supported.[14] Exit policies from government ownership or support may present additional challenges that require attention in order to ensure good governance. Likewise, these principles apply to banks with other types

---

[12] For further information on "fit and proper" tests, see *Core Principles for Effective Banking Supervision* and the related *Core Principles Methodology*, Basel Committee on Banking Supervision, October 2006, available at www.bis.org/publ/bcbs129.htm and www.bis.org/publ/bcbs130.htm.

[13] The foundations of effective corporate governance are comparable to the preconditions for effective banking supervision cited in *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.

[14] 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, available at www.oecd.org/dataoecd/46/51/34803211.pdf.

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 (including, for example, cooperative banking organisations).

III. Sound corporate governance principles

19. 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.

A. Board practices

Board's overall responsibilities

Principle 1

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management.

Responsibilities of the board

20. The board has ultimate responsibility for the bank's business, risk strategy and financial soundness, as well as for how the bank organises and governs itself.

21. Accordingly, the board should:

- approve the overall business strategy of the bank, taking into account the bank's long-term financial interests and safety; and
- approve and oversee the implementation of the bank's:
  - overall risk strategy, including its risk tolerance/appetite;
  - risk policy, risk management and internal control systems, including compliance policy; and
  - corporate governance principles and corporate values, including a code of conduct or comparable document.

22. In discharging these responsibilities, the board should take into account the legitimate interests of shareholders, depositors and other relevant stakeholders. It should also ensure that the bank maintains an effective relationship with its supervisors.

23. The members of the board should exercise their "duty of care" and "duty of loyalty"[15] to the bank under applicable national laws and supervisory standards. This includes

[15] The OECD defines "duty of care" as "The duty of a board member to act on an informed and prudent basis in decisions with respect to the company. Often interpreted as requiring the board member to approach the affairs of the company in the same way that a 'prudent man' would approach their own affairs. Liability under

engaging actively in the major matters of the bank and keeping up with material changes in the bank's business and the external environment, as well as acting to protect the interests of the bank.

24. The board should give particular attention to ensuring that transactions with related parties are reviewed to assess risk and are subject to appropriate restrictions (eg by requiring that such transactions be conducted at arms-length terms) and that corporate or business resources of the bank are not misappropriated.

Oversight of senior management

25. Except where required otherwise by applicable law or regulations, the board should select and, where necessary, replace senior management and have in place an appropriate plan for succession.

26. The board should provide oversight of senior management as part of the bank's checks and balances. In doing so the board should:

- monitor that senior management's actions are consistent with the strategy and policies approved by the board, including the risk tolerance/appetite;
- meet regularly with senior management;
- question and review critically explanations and information provided by senior management; and
- set formal performance standards for senior management consistent with the long-term objectives, strategy and financial soundness of the bank, and monitor senior management's performance against these standards.

27. The board should also ensure that the bank's organisational structure facilitates effective decision making and good governance. This should include setting and enforcing lines of responsibility and accountability throughout the organisation, which define clearly the key responsibilities and authorities of the board itself, as well as of senior management and the control functions.

28. The board should regularly review policies, processes and controls with senior management and/or internal control functions (including internal audit, risk management and compliance) in order to determine areas needing improvement, as well as to identify and address significant risks and issues. The board should ensure that the control functions are properly positioned, staffed and resourced and are carrying out their responsibilities independently and effectively.

Corporate values and code of conduct

29. A demonstrated corporate culture that supports and provides appropriate norms and incentives for professional and responsible behaviour is an essential foundation of good governance. In this regard, the board should take the lead in establishing the "tone at the

---

the duty of care is frequently mitigated by the business judgement rule." The OECD also defines "duty of loyalty" as "The duty of the board member to act in the interest of the company and shareholders. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders." See footnote 4 for reference.

top" and setting professional standards and corporate values that promote integrity for itself, senior management and other employees.

30. A bank's code of conduct, or comparable document, should articulate acceptable and unacceptable behaviours. It is especially important that such a document disallows behaviour that could result in the bank engaging in any improper or illegal activity, such as money laundering, fraud, bribery or corruption. It should also discourage excessive risk taking activities.

31. The bank's corporate values should recognise the critical importance of timely and frank discussion and elevation of problems to higher levels within the organisation. In this regard, employees should be encouraged and able to communicate, with 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 confidentially material and bona fide concerns or observations of any violations. Communication should be allowed to be channelled to the board - directly or indirectly (eg through an independent audit or compliance process or through an ombudsman) - and independent of the internal "chain of command". The board should determine how and by whom such legitimate concerns shall be investigated and addressed, such as by an internal control function, an objective external party, senior management and/or the board itself.

32. The board should ensure that appropriate steps are taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies and procedures, such as the means to report confidentially concerns or violations to an appropriate body.

Board Qualifications

Principle 2

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

33. This principle applies to a board member in his or her capacity as a member of the full board and as a member of any board committee.

Qualifications

34. The board should possess, both as individual board members and collectively, appropriate experience, competencies and personal qualities, including professionalism and personal integrity.[16]

35. The board collectively should have adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue in order to enable effective

---

[16] See Principle 3 of the *Core Principles Methodology*, Basel Committee on Banking Supervision, October 2006. When a bank is authorised, the licensing authority is expected to evaluate proposed board members and senior managers for fitness and propriety.

governance and oversight. Examples of areas where the board should seek to have, or have access to, appropriate experience or expertise include finance, accounting, strategic planning, communications, governance, risk management, bank regulation, auditing and compliance.

Training

36. In order to help board members acquire, maintain and deepen their knowledge and skills and to fulfil their responsibilities, the board should ensure that board members have access to programmes of tailored initial (eg induction) and ongoing education on relevant issues. The board should dedicate sufficient time, budget and other resources for this purpose.

Composition

37. The bank should have an adequate number and appropriate composition of board members. Unless required otherwise by law, the board should identify and nominate candidates and ensure appropriate succession planning. Board perspective and ability to exercise objective judgment independent[17] of both the views of executives and of inappropriate political or personal interests can be enhanced by recruiting members from a sufficiently broad population of candidates. Independence can be enhanced by including a sufficient number of qualified non-executive members on the board who are capable of exercising sound objective judgement. Where a supervisory board or board of auditors is formally separate from a management board, objectivity and independence still needs to be assured by appropriate selection of board members.[18]

38. In identifying potential board members, the board should ensure that the candidates are qualified to serve as board members and are able to commit the necessary time and effort to fulfil their responsibilities. Serving as a board member or senior manager of a company that competes or does business with the bank can compromise board independent judgment, as can cross-membership of boards.

Board's own practices and structure

Principle 3

The board should define appropriate governance practices for its own work and have in place the means to ensure such practices are followed and periodically reviewed for improvement.

---

[17] Definitions of what constitutes “independence” for board members 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, independent judgment after fair consideration of all relevant information and views without undue influence from executives or from inappropriate external parties or interests.

[18] If a former executive of the company, whether the chief executive officer (CEO) or not, is being considered to serve on the board of the company, the board should carefully review any potential conflicts of interest that might arise from this, particularly if this person is to carry out the role of chair of the board or of a committee of the board. If the board deems it to be in the interest of the company to have this person serve on the board, appropriate processes to mitigate the potential conflicts of interest should be put in place, such as a waiting period and/or a description of matters on which the person should recuse himself or herself to avoid a conflict of interest.

39. The board should exemplify through its own practices sound governance principles. These practices help the board carry out its duties more effectively. At the same time, they send important signals internally and externally about the kind of enterprise the bank aims to be.

Organisation and functioning of the board

40. The board should maintain, and periodically update, organisational rules, by-laws, or other similar documents setting out its organisation, rights, responsibilities and key activities.

41. The board should structure itself in a way, including in terms of size, frequency of meetings and the use of committees, so as to promote efficiency, sufficiently deep review of matters, and robust, critical challenge and discussion of issues.

42. To support board performance, it is a good practice for the board to carry out regular assessments of both the board as a whole and of individual board members. Assistance from external facilitators in carrying out board assessments can contribute to the objectivity of the process. Where the board has serious reservations about the performance or integrity of a board member, the board should take appropriate actions. Either separately or as part of these assessments, the board should periodically review the effectiveness of its own governance practices and procedures, determine where improvements may be needed, and make any necessary changes.

Role of the chair

43. The chair of the board plays a crucial role in the proper functioning of the board. He or she provides leadership to the board and is responsible for the board's effective overall functioning.

44. The chair should ensure that board decisions are taken on a sound and well-informed basis. He or she should encourage and promote critical discussion and ensure that dissenting views can be expressed and discussed within the decision-making process.

45. To achieve appropriate checks and balances, an increasing number of banks require the chair of the board to be a non-executive, except where otherwise required by law. Where a bank does not have this separation and particularly where the roles of the chair of the board and CEO are vested in the same person, it is important for the bank to be prepared to explain as necessary to interested parties why this is the case and to have measures in place to minimise the impact on the bank's checks and balances of such a situation (such as, for example, by having a lead director, senior independent director or a similar position).

Board committees

46. To increase efficiency and allow deeper focus in specific areas, boards in many jurisdictions establish certain specialised board committees. The number and nature of committees depends on many factors, including the size of the bank and its board, the nature of the business areas of the bank, and its risk profile.

47. Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures. In the interest of greater transparency and accountability, a board should disclose the committees it has established, their mandates, and their composition (including members who are considered to be independent). To avoid undue concentration of power and to promote fresh perspectives, it may be useful to consider occasional rotation of membership and chairmanship of such committees.

48. For large banks and internationally active banks, an audit committee or equivalent should be required. The audit committee typically is responsible for the financial reporting process; providing oversight of the bank's internal and external auditors; approving, or recommending to the board or shareholders for their approval, the appointment,[19] compensation and dismissal of external auditors; reviewing and approving the audit scope and frequency; receiving audit reports;[20] and ensuring that senior management (with the appropriate involvement from the control functions) is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations and other problems identified by auditors. In addition, the audit committee should oversee the establishment of accounting policies by the bank.

49. It is advisable that the audit committee consists of a sufficient number of independent non-executive board members. In jurisdictions where external auditors are selected by the audit committee, it may be beneficial for the appointment or dismissal of 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 the duties to be performed - in financial reporting, accounting and auditing.

50. It is also appropriate for many banks, especially large banks and internationally active banks, to have a board-level risk committee or equivalent, responsible for advising the board on the bank's overall current and future risk tolerance/appetite and strategy, and for overseeing senior management's implementation of that strategy. This should include strategies for capital and liquidity management, as well as for credit, market, operational, compliance, reputational and other risks of the bank. To enhance the effectiveness of the risk committee, it should receive formal and informal communication from the bank's risk management function and chief risk officer (see Principle 6), and should, where appropriate, have access to external expert advice, particularly in relation to proposed strategic transactions, such as mergers and acquisitions.

51. Among other specialised committees that have become increasingly common among banks are the following:

- *Compensation committee* - sets and oversees the compensation system's design and operation, and ensures that compensation is appropriate and consistent with the bank's culture, long-term business and risk strategy, performance and control environment (see Principles 10 and 11), as well as with any legal or regulatory requirements.
- *Nominations/human resources/governance committee* - provides recommendations to the board for new board members and members of senior management; may be involved in assessment of board and senior management effectiveness; may be involved in overseeing the bank's personnel or human resource policies.
- *Ethics/compliance committee* - focuses on ensuring that the bank has the appropriate means for promoting proper decision making and compliance with laws, regulations and internal rules; provides oversight of the compliance function.

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

[20] As well as risk management and compliance reports, unless the bank has separate board committees for these areas.

52. The board should appoint members to specialised committees with the goal of achieving an optimal mix of skills and experience that, in combination, allow the committees to fully understand, objectively evaluate and bring fresh thinking to the relevant issues. In order to achieve the needed objectivity, membership should be composed of non-executive and to the extent possible, a majority of independent members. In cases where a pool of independent candidates is not available, committee membership should strive to mix skills and experience in order to maximise objectivity. Notwithstanding the composition of the specialised committees, it may be beneficial for independent members to meet separately, both among themselves and with the relevant control areas, on a regular basis to ensure frank and timely dialogue.

Conflicts of interest

53. Conflicts of interest may arise as a result of the various activities and roles of the bank (eg 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 board members or senior managers (eg where the bank enters into a business relationship with an entity owned by one of the bank's board members). Conflicts of interest may also arise when a bank is part of a broader group. For example, where the bank is part of a group, reporting lines and information flows between the bank, its parent company and/or other subsidiaries can lead to the emergence of similar conflicts of interest (eg sharing of potential proprietary, confidential or otherwise sensitive information from different entities). The board should ensure that policies to identify potential conflicts of interest are developed and implemented and, if these conflicts cannot be prevented, are appropriately managed (based on the permissibility of relationships or transactions under sound corporate policies consistent with national law and supervisory standards).

54. The board should have a formal written conflicts of interest policy and an objective compliance process for implementing the policy. The policy should include:

- a member's duty to avoid to the extent possible activities that could create conflicts of interest or the appearance of conflicts of interest;
- a review or approval process for members to follow before they engage in certain activities (such as serving on another board) so as to ensure that such activity will not create a conflict of interest;
- a member's duty to disclose any matter that may result, or has already resulted, in a conflict of interest;
- a member's responsibility to abstain from voting on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfil duties to the bank may be otherwise compromised;
- adequate procedures for transactions with related parties to be made on an arms-length basis; and
- the way in which the board will deal with any non-compliance with the policy.

55. It is a leading practice to include in any conflicts of interest policy examples of where conflicts can arise when serving as a board member.

56. The board should ensure that appropriate public disclosure is made, and/or information is provided to supervisors, relating to the bank's policies on conflicts of interest and potential conflicts of interest. This should include information on the bank's approach to managing material conflicts of interest that are not consistent with such policies; and conflicts

that could arise as a result of the bank's affiliation or transactions with other entities within the group.

57. 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.

Controlling shareholders

58. Where there are controlling shareholders with power to appoint board members, the board should exercise corresponding caution. In such cases, it is useful to bear in mind that the board members have responsibilities to the bank itself, regardless of who appoints them. In cases where there are board members appointed by a controlling shareholder, the board may wish to set out specific procedures or conduct periodic reviews to ensure the appropriate discharge of responsibilities by all board members.

Group Structures

Principle 4

In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

59. The board of a regulated banking subsidiary at the legal entity level should adhere to the same corporate governance principles as those expected for its parent company absent other legal requirements or reasons of proportionality. However, the group dimension is likely to affect to a certain extent the corporate governance structure of both parent and subsidiaries, and therefore boards should pay attention to how to apply the principles, including taking in consideration the points stated below.

Board of parent company

60. In the discharge of its corporate governance responsibilities, the board of the parent company should be aware of the material risks and issues that might affect both the bank as a whole and its subsidiaries. It should therefore exercise adequate oversight over subsidiaries, while respecting the independent legal and governance responsibilities that might apply to regulated subsidiary boards.

61. In order to fulfil its corporate governance responsibilities, the board of the parent company should:

- establish a governance structure which contributes to the effective oversight of subsidiaries and which takes into account the nature, scale and complexity of the different risks to which the group and its subsidiaries are exposed;
- set and approve a corporate governance policy at the group level for its subsidiaries, which includes the commitment to meet all applicable governance requirements;
- ensure that enough resources are available for each subsidiary to meet both group standards and local governance standards; and
- have appropriate means to monitor that each subsidiary complies with all applicable governance requirements.

Board of regulated subsidiary

62. The board of a regulated banking subsidiary should retain and set its own corporate governance responsibilities, and should evaluate any group-level decisions or practices to ensure that they do not put the regulated subsidiary in breach of applicable legal or regulatory provisions or prudential rules.[21] The board of the regulated banking subsidiary should also ensure that such decisions or practices are not detrimental to:

- the sound and prudent management of the subsidiary;
- the financial health of the subsidiary; or
- the legal interests of the subsidiary's stakeholders.

B. Senior management

Principle 5

Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.

63. Senior management consists of a core group of individuals who are responsible and should be held accountable for overseeing the day-to-day management of the bank. These individuals should have the necessary experience, competencies and integrity to manage the businesses under their supervision as well as have appropriate control over the key individuals in these areas.

64. Senior management contributes substantially to a bank's sound corporate governance through personal conduct (eg by helping to set the "tone at the top" along with the board) by providing adequate oversight of those they manage, and by ensuring that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the bank's board.

65. Senior management is responsible for delegating duties to the staff and should establish a management structure that promotes accountability. Senior management should remain cognisant of its obligation to oversee the exercise of such delegated responsibility and its ultimate responsibility to the board for the performance of the bank.

66. Senior management should implement appropriate systems for managing the risks - both financial and non-financial - to which the bank is exposed. This includes a comprehensive and independent risk management function and an effective system of internal controls. These should be designed and operated to ensure adherence to the bank's strategy and risk tolerance/appetite (which should also be in line with each other, as discussed in greater detail in Principles 6-7 below).

[21] In some jurisdictions, in order to exercise its corporate governance responsibilities independently, the board of the subsidiary is expected to have an adequate number of qualified, independent non-executive board members, who devote sufficient time to the matters of the subsidiary.

C. Risk management and internal controls

Principle 6

Banks should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

Risk management vs. internal controls[22]

67. Risk management generally encompasses the process of:

- identifying key risks to the bank;
- measuring exposures to those risks;
- monitoring risk exposures and determining the corresponding capital needs (ie capital planning) on an ongoing basis;[23]
- taking steps to control or mitigate risk exposures; and
- reporting to senior management and the board on all the items noted in this paragraph.

68. Internal controls are designed, among other things, to ensure that each key risk has a process or other measure to help contain or control that risk and that such process or measure is being applied and works as intended. As such, internal controls help ensure process integrity, compliance and effectiveness. Internal controls help provide comfort that financial and management information is reliable, timely and complete and that the bank is in compliance with its various obligations, including applicable laws and regulations.[24] In order to avoid actions beyond the authority of the individual or even fraud, internal controls also place reasonable checks on managerial and employee discretion. Even in very small banks, for example, key management decisions should be made by more than one person ("four eyes principle"). Internal control reviews should also determine the extent of an institution's compliance with company policies and procedures, as well as with legal and regulatory policies.

Chief risk officer or equivalent

69. Large banks and internationally active banks, and others depending on their risk profile and local governance requirements, should have an independent senior executive with distinct responsibility for the risk management function and the institution's comprehensive risk management framework across the entire organisation. This executive is commonly referred to as the chief risk officer (CRO). Since some banks may have an officer who fulfils the function of a CRO but has a different title, reference in this guidance to the

---

[22] While risk management and internal controls are discussed separately in this document, some supervisors or banks may use "internal controls" as an umbrella term to include risk management, internal audit, compliance, etc. The two terms are in fact closely related and the distinction between risk management and internal controls is less important than achieving, in practice, the objectives of each.

[23] While the design and execution of a bank's capital planning process may primarily be the responsibility of the chief financial officer (CFO), the treasury function, or other entities within the bank, the risk management function should be able to explain clearly and monitor on an ongoing basis the bank's capital and liquidity position and strategy.

[24] See *Framework for Internal Control Systems in Banking Organisations*, Basel Committee on Banking Supervision, September 1998, available at www.bis.org/publ/bcbs40.htm.

CRO is intended to incorporate equivalent positions. Whatever the title, at least in large banks, the role of the CRO should be distinct from other executive functions and business line responsibilities, and there generally should be no "dual hatting" (ie the chief operating officer, CFO or other senior management should not also serve as the CRO).[25]

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

71. The CRO should have sufficient stature, authority and seniority within the organisation. This will typically be reflected in the ability of the CRO to influence decisions that affect the bank's exposure to risk. Beyond periodic reporting, the CRO should thus have the ability to engage with the board and other senior management on key risk issues and to access such information as the CRO deems necessary to form his or her judgement. Such interactions should not compromise the CRO's independence.

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

Scope of responsibilities, stature and independence of the risk management function

73. The risk management function is responsible for identifying, measuring, monitoring, controlling or mitigating, and reporting on risk exposures. This should encompass all risks to the bank, on- and off-balance sheet and at a group-wide, portfolio and business-line level.

74. The risk management function, under the direction of the CRO, should have sufficient stature within the bank such that issues raised by risk managers receive the necessary attention from the board, senior management and business lines. Business decisions by the bank typically are a product of many considerations. By properly positioning and supporting its risk management function, a bank helps ensure that the views of risk managers will be an important part of those considerations.

75. While it is not uncommon for risk managers to work closely with individual business units and, in some cases, to have dual reporting lines, the risk management function should be sufficiently independent of the business units whose activities and exposures it reviews. While such independence is an essential component of an effective risk management function, it is also important that risk managers are not so isolated from business lines - geographically or otherwise - that they cannot understand the business or access necessary information. Moreover, the risk management function should have access to all business lines that have the potential to generate material risk to the bank. Regardless of any responsibilities that the risk management function may have to business lines and senior management, its ultimate responsibility should be to the board.

[25] Where such "dual hatting" does occur (eg in smaller institutions where resource constraints may make overlapping responsibilities necessary), these roles should be compatible and should not weaken checks and balances within the bank.

Resources

76. A bank should ensure through its planning and budgeting processes that the risk management function has adequate resources (in both number and quality) necessary to assess risk, including personnel, access to information technology systems and systems development resources, and support and access to internal information. These processes should also explicitly address and provide sufficient resources for internal audit and compliance functions. Compensation and other incentives (eg opportunities for promotion) of the CRO and risk management staff should be sufficient to attract and retain qualified personnel.

Qualifications

77. Risk management personnel should possess sufficient experience and qualifications, including market and product knowledge as well as mastery of risk disciplines.[26] Staff should have the ability and willingness to challenge business lines regarding all aspects of risk arising from the bank's activities.

Principle 7

Risks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile (including its growth), and to the external risk landscape.

Risk methodologies and activities

78. Risk analysis should include both quantitative and qualitative elements. While risk measurement is a key component of risk management, excessive focus on measuring or modelling risks at the expense of other risk management activities may result both in overreliance on risk estimates that do not accurately reflect real exposures and in insufficient action to address and mitigate risks. The risk management function should ensure that the bank's internal risk measurements cover a range of scenarios, are not based on overly optimistic assumptions regarding dependencies and correlations, and include qualitative firm-wide views of risk relative to return and to the bank's external operating environment. Senior management and, as applicable, the board should review and approve scenarios that are used in the bank's risk analysis and should be made aware of assumptions and potential shortcomings embedded in the bank's risk models.

79. As banks make use of certain internal and external data to identify and assess risk, make strategic or operational decisions, and determine capital adequacy, the board should give special attention to the quality, completeness and accuracy of the data it relies on to make risk decisions.

---

[26] Some firms have found it to be a sound practice to encourage or require staff to serve in both business line and risk management roles, on a rotational basis, as a requirement for career development. Such an approach can have several benefits, including giving risk management stature within the bank commensurate with business lines and other functions, promoting firm-wide dialogue regarding risk, and ensuring that business lines understand the importance of risk management and that risk managers understand how business lines operate.

80. As part of its quantitative and qualitative analysis, the bank should also utilise forward-looking stress tests and scenario analysis to better understand potential risk exposures under a variety of adverse circumstances.[27] These should be key elements of a bank's risk management process, and the results should be communicated to, and given appropriate consideration by, the relevant business lines and individuals within the bank. A forward-looking approach to risk management should include ongoing monitoring of existing risks as well as identifying new or emerging risks.

81. In addition to these forward-looking tools, banks should also regularly review actual performance after the fact relative to risk estimates (ie backtesting) to assist in gauging the accuracy and effectiveness of the risk management process and making necessary adjustments.

82. The risk management function should promote the importance of senior management and business line managers in identifying and assessing risks critically, rather than relying excessively on external risk assessments. While external assessments such as external credit ratings or externally purchased risk models can be useful as an input into a more comprehensive assessment of risk, the ultimate responsibility for assessing risk lies solely with the bank. For example, in the case of a purchased credit or market risk model, the bank should take the steps necessary to validate the model and calibrate it to the bank's individual circumstances to ensure accurate and comprehensive capture and analysis of risk. In any case, banks should avoid over-reliance on any specific risk methodology or model.

83. In the case of subsidiary banks, a similar approach is necessary. The board and management of a subsidiary remain responsible for effective risk management processes at the subsidiary. While parent companies should conduct strategic, group-wide risk management and prescribe corporate risk policies, subsidiary management and boards should have appropriate input into their local or regional adoption and to assessments of local risks. If group risk management systems and processes are prescribed, subsidiary management, with subsidiary board oversight, is responsible for ensuring the proper validation of these systems. Furthermore, adequate stress testing of subsidiary portfolios should occur, based not only on the subsidiaries' economic and operating environments, but also based on the ramifications of potential stress on the parent company (eg liquidity, credit, reputational risk, etc). In some cases, such evaluations may be accomplished through joint head office and subsidiary teams. Irrespective of the use of parent company models and systems, the daily operational management of risk cannot be delegated away from the subsidiary. Local management and control functions remain responsible and accountable for prudent risk management at the local level. Parent companies should ensure that adequate tools and authorities are provided to the subsidiary and that the subsidiary understands what reporting obligations it has to the head office.

84. In addition to identifying and measuring risk exposures, the risk management function should evaluate possible ways to manage these exposures. In some cases, the risk management function may direct that risk be reduced or hedged to limit exposure. In other cases, the risk management function may simply report risk positions and monitor these positions to ensure that they remain within the bank's framework of limits and controls. Either approach may be appropriate provided the independence of the risk management function is not compromised.

---

[27] See *Principles for Sound Stress Testing Practices and Supervision*, Basel Committee on Banking Supervision, May 2009, available at www.bis.org/publ/bcbs155.htm.

85. The sophistication of the bank's risk management and internal control infrastructures - including, in particular, a sufficiently robust information technology infrastructure - should keep pace with developments such as balance sheet and revenue growth, increasing complexity of the bank's business or operating structure, geographic expansion, mergers and acquisitions, or the introduction of new products or business lines. Strategic business planning, and periodic review of such plans, should take into account the extent to which such developments have occurred and the likelihood that they will continue going forward.

86. Banks should have approval processes for new products. These should include an assessment of the risks of new products, significant changes to existing products, the introduction of new lines of business and entry into new markets. The risk management function should provide input on risks as a part of such processes. This should include a full and frank assessment of risks under a variety of scenarios, as well as an assessment of potential shortcomings in the ability of the bank's risk management and internal controls to effectively manage associated risks. In this regard, the bank's new product approval process should take into account the extent to which the bank's risk management, legal and regulatory compliance, information technology, business line, and internal control functions have adequate tools and the expertise necessary to manage related risks. If adequate risk management processes are not yet in place, a new product offering should be delayed until such time that systems and risk management are able to accommodate the relevant activity. There should also be a process to assess risk and performance relative to initial projections, and to adapt the risk management treatment accordingly, as the business matures.

87. Mergers and acquisitions can pose special risk management challenges to the bank. In particular, risks can arise from conducting insufficient due diligence that fails to identify risks that arise post-merger. The risk management function should therefore be actively involved in assessing risks that could arise from mergers and acquisitions, and should report its findings directly to the board.

88. While the risk management function plays a vital role in identifying, measuring, monitoring and reporting on risk exposures, other units in the bank also play an important role in managing risk. In addition to business lines, which should be accountable for managing risks arising from their activities, the bank's treasury and finance functions should promote effective firm-wide risk management not only through supporting financial controls but also through applying robust internal pricing of risk. A business unit's internal cost of funds should reflect material risks to the bank arising from its activities. Failure to do so may result in greater investment in high-risk activities than would be the case if internal pricing were risk-adjusted.

89. Although the risk management function has a key leadership and coordinating role on risks, responsibility for managing risk ultimately extends to every employee of a bank. All management and staff, therefore, should be aware of, and be held accountable for, their risk management responsibilities. As noted in Principle 1 above, the board and senior management should promote a culture of risk awareness and risk management within the bank.

Principle 8

Effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

90. The bank's risk exposures and strategy should be communicated throughout the bank with sufficient frequency. Effective communication, both horizontally across the

organisation and vertically up the management chain, facilitates effective decision-making that fosters safe and sound banking and helps prevent decisions that may result in amplifying risk exposures.

91. Information should be communicated to the board and senior management in a timely, complete, understandable and accurate manner so that they are equipped to make informed decisions. This is particularly important when a bank is facing financial or other difficulties and may need to make prompt, critical decisions. If the board and senior management have incomplete or inaccurate information, their decisions may magnify risks rather than mitigate them. Serious consideration should be given by the board to instituting periodic reviews of the amount and quality of information the board receives or should receive.

92. In ensuring that the board and senior management are sufficiently informed, management and the control functions should strike a balance between communicating information that is accurate and "unfiltered" (ie that does not hide potentially bad news) and not communicating so much extraneous information that the sheer volume of information becomes counterproductive.

93. Risk reporting to the board requires careful design in order to ensure that firm-wide and individual portfolio and other risks are conveyed in a concise and meaningful manner. Reporting should accurately communicate risk exposures and results of stress tests or scenario analyses, and should provoke a robust discussion of, for example, the bank's current and prospective exposures (particularly under stressed scenarios), risk/return relationships, risk tolerance/appetite, etc. In addition to internal measurement and assessment of bank risks, reporting should include information about the external environment to identify market conditions and trends that may have a bearing on the bank's current or future risk profile.

94. Risk reporting systems should be dynamic, comprehensive and accurate, and should draw on a range of underlying assumptions. Risk monitoring and reporting should occur not only at the disaggregated level (including risk residing in subsidiaries that could be considered significant), but should also be aggregated upward to allow for a firm-wide or consolidated picture of risk exposures. Risk reporting systems should be clear about any deficiencies or limitations in risk estimates, as well as any significant embedded assumptions (eg regarding risk dependencies or correlations). These systems should not only aggregate information to provide a firm-wide, integrated perspective on risk (geographically and by risk type), but should also highlight emerging risks that have the potential to become significant and may merit further analysis.

95. In this regard, organisational "silos"[28] can impede effective sharing of information across a bank and can result in decisions being made in isolation from the rest of the bank.[29] Overcoming information-sharing obstacles posed by silo structures may require the board and senior management to review or rethink established practices in order to encourage greater communication. Some firms have found it useful to create risk management committees - distinct from the board's risk committee - that draw members from across the

[28] Organisational silos can be characterised by business lines, legal entities, and/or geographic units being run in isolation from each other, with limited information shared and, in some cases, competition across silos.

[29] This observation was highlighted in the March 2008 Senior Supervisors Group report on *Observations on Risk Management Practices during the Recent Market Turbulence*. See footnote 5 for reference.

firm (eg from business lines and the risk management function) to discuss issues related to firm-wide risks.

Principle 9

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

96. The board should recognise and acknowledge that independent, competent and qualified internal and external auditors, as well as other internal control functions (including the compliance functions), are vital to the corporate governance process in order to achieve a number of important objectives. Senior management should also recognise the importance of the effectiveness of these functions to the long-term soundness of the bank.

97. The board and senior management can enhance the ability of the internal audit function[30] to identify problems with a bank's risk management and internal control systems by:

- encouraging internal auditors to adhere to national and international professional standards, such as those established by the Institute of Internal Auditors;
- promoting the independence of the internal auditor, for example by ensuring that internal audit reports and/or has direct access to the board or the board's audit committee;
- 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 identified problems by senior management; and
- engaging internal auditors to judge the effectiveness of the risk management and compliance function, including the quality of risk reporting to the board and senior management, as well as the effectiveness of other key control functions.

98. The board and senior management are responsible for the preparation and fair presentation of financial statements in accordance with applicable accounting standards in each jurisdiction, as well as the establishment of effective internal controls related to financial reporting. The board and senior management can also contribute to the effectiveness of external auditors[31] 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, for example, including in engagement letters the expectation that the external auditor will be in compliance with applicable domestic and international codes and standards of professional practice.

99. Non-executive board members should have the right to meet regularly - in the absence of senior management - with the external auditor and the heads of the internal audit and compliance functions. This can strengthen the ability of the board to oversee senior

---

[30] See *Internal Audit in Banks and the Supervisor's Relationship with Auditors*, Basel Committee on Banking Supervision, August 2001, available at www.bis.org/publ/bcbs84.htm.

[31] See *External Audit Quality and Banking Supervision*, Basel Committee on Banking Supervision, December 2008, available at www.bis.org/publ/bcbs146.htm and *The Relationship Between Banking Supervisors and Banks' External Auditors*, Basel Committee on Banking Supervision, January 2002, available at www.bis.org/publ/bcbs87.htm.

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 board.

100. The bank should maintain sound control functions, including an effective compliance function that, among other things, routinely monitor compliance with laws, corporate governance rules, regulations, codes and policies to which the bank is subject and ensure that deviations are reported to an appropriate level of management and, in case of material deviations, to the board.[32]

101. Senior management should promote strong internal controls and should avoid activities and practices that undermine their effectiveness. For example, senior management should ensure there is effective segregation of duties where conflicts could arise. It should also exercise effective control over employees in key business positions (even apparent "star" employees). This latter point has proven especially problematic where managers have failed to question employees who generate revenues or returns out of line with reasonable expectations (eg where supposedly low-risk, low-margin trading activity generated unexpectedly high returns) for fear of losing either revenue or the employee.

D. Compensation

102. Compensation systems contribute to bank performance and risk-taking, and should therefore be key components of a bank's governance and risk management. In practice, however, risk has not always been taken into account in determining compensation practices, with the result that some long-term risks may have been exacerbated by compensation incentives, such as those to boost short-term profits. In recognition of this, the FSB issued the FSB Principles in April 2009 and the accompanying FSB Standards in September 2009 to assist in their implementation. In addition, the Committee issued in January 2010 a document on *Compensation Principles and Standards Assessment Methodology*.[33]

103. Banks should fully implement the FSB Principles and Standards, or the applicable national provisions that are consistent with the FSB Principles and Standards. While Principles 10 and 11 below reflect some of the key corporate governance-related elements of the FSB Principles, banks are expected to comply with the FSB Principles and Standards in their entirety. The FSB Principles and Standards are intended to apply to significant financial institutions, but national jurisdictions may also apply them in a proportionate manner to smaller, less-complex institutions.

---

[32] See *Compliance and the Compliance Function in Banks*, Basel Committee on Banking Supervision, April 2005, available at www.bis.org/publ/bcbs113.htm. 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. In some cases, banks' compliance functions have been designed to address only anti-money laundering issues, which is inconsistent with Basel Committee guidance. The compliance function should have a broader scope and address the areas indicated in this paragraph and in the Basel Committee guidance.

[33] See *Compensation Principles and Standards Assessment Methodology*, Basel Committee on Banking Supervision, January 2010, available at www.bis.org/publ/bcbs166.htm. This document aims to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB Principles and Standards, and seeks to foster supervisory approaches that are effective in promoting sound compensation practices at banks and help support a level playing field.

Principle 10

The board should actively oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended.

104. The board is responsible for the overall design and operation of the compensation system for the entire bank.[34] As such, those board members who are most actively involved in the design and operation of the compensation system (eg as members of the board's compensation committee) should be independent, non-executive members with substantial knowledge about compensation arrangements and the incentives and risks that can arise from such arrangements. Because compensation should be aligned with risk (as discussed in Principle 11 below), an understanding of the firm's risk measurement and management, and of how different compensation practices can impact the firm's risk profile, is important as well. Board compensation committees should also meet the criteria set forth in the "Governance" section of the FSB Standards, including working closely with the board's risk committee to evaluate incentives arising from compensation and ensuring that an annual compensation review is undertaken.

105. In addition to establishing the compensation system, the board should monitor and review outcomes to ensure that the compensation system is operating as intended. For example, the board should ensure that lower risk-adjusted income in a business line will result in reduced compensation.

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

Principle 11

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

107. Since employees can generate equivalent short-term revenues while taking on vastly different amounts of risk in the longer term, a bank should ensure that variable compensation is adjusted to take into account the risks an employee takes. This should consider all types of risk over a timeframe sufficient for risk outcomes to be revealed. It is appropriate to use both quantitative risk measures and human judgment in determining risk adjustments. Where firms make such adjustments, all material risks should be taken into account, including difficult-to-measure risks (eg reputational risk) and potentially severe risk outcomes.

---

[34] While the board is responsible for the overall compensation system for the bank, this does not mean that the board or its compensation committee is responsible for determining compensation for large numbers of individual employees. The board should, however, develop and issue the compensation policy for the bank as a whole, determine the bonus pool, and review and approve compensation for senior management and for the highest paid non-executive employees in the firm.

108. In addition to ex ante risk adjustments, banks should take other steps to better align compensation with prudent risk taking. One characteristic of effective compensation outcomes is that they are symmetric with risk outcomes, particularly at the bank or business line level. That is, the size of the bank's variable compensation pool should vary in response to both positive and negative performance. Variable compensation should be diminished or eliminated when a bank or business line incurs substantial losses.

109. Compensation should be sensitive to risk outcomes over a multi-year horizon. This is typically achieved through arrangements that defer compensation until risk outcomes have been realised, and may include so-called "malus" or "clawback" provisions whereby compensation is reduced or reversed if employees generate exposures that cause the bank to perform poorly in subsequent years or if the employee has failed to comply with internal policies or legal requirements. "Golden parachute" arrangements under which terminated executives or staff receive large payouts irrespective of performance are generally not consistent with sound compensation practice.

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

E. Complex or opaque corporate structures

Principle 12

The board and senior management should know and understand the bank's operational structure and the risks that it poses (ie "know-your-structure").

111. Some banks create structures for legal, regulatory, fiscal or product-offering purposes in the form of units, branches, subsidiaries or other legal entities that can considerably increase the complexity of the organisation. The sheer number of legal entities, and in particular the interconnections and intra-group transactions among such entities, can lead to challenges in identifying, overseeing and managing the risks of the organisation as a whole, which is a risk in and of itself.

112. The board and senior management should understand the structure and the organisation of the group, ie the aims of its different units/entities and the formal and informal links and relationships among the entities and with the parent company. This includes understanding the legal and operational risks and constraints of the various types of intra-group exposures and transactions and how they affect the group's funding, capital and risk profile under normal and adverse circumstances. Sound and effective measures and systems should be in place to facilitate the generation and exchange of information among and about the various entities, to manage the risks of the group as a whole, and for the effective supervision of the group.

113. Another governance challenge arises when banks establish business or product line management structures that do not match the bank's legal entity structure. While this is a quite common practice, it nevertheless introduces additional complexity. Apart from ensuring the appropriateness of these matrix structures, the board or senior management as appropriate should ensure that all products and their risks are captured and evaluated on an individual entity and group-wide basis.

114. The board should approve policies and clear strategies for the establishment of new structures and should properly guide and understand the bank's structure, its evolution and its limitations. Moreover, the board and senior management as appropriate should:

- avoid setting up unnecessarily complicated structures;
- have a centralised process for approving and controlling the creation of new legal entities based on established criteria, including the ability to monitor and fulfil on an ongoing basis each entity's requirements (eg regulatory, tax, financial reporting, governance);
- understand and be able to produce information regarding the bank's structure, including the type, charter, ownership structure and businesses conducted for each legal entity;
- recognise the risks that the complexity of the legal entity structure itself may pose, including lack of management transparency, operational risks introduced by interconnected and complex funding structures, intra-group exposures, trapped collateral and counterparty risk; and
- evaluate how the aforementioned risks of the structure and legal entity requirements affect the group's ability to manage its risk profile and deploy funding and capital under normal and adverse circumstances.

115. In order to enhance the sound governance of a banking group, internal audits of individual entities could be complemented with regular assessments of the risks posed by the group's structure. Periodic reports that assess the bank's overall structure and individual entities' activities, confirm compliance with the strategy previously approved by the board, and disclose any possible discrepancies could be useful for the audit and risk committees, senior management and the board of the parent company.

116. The bank should discuss with, and/or report to, its supervisor regarding policies and procedures for the creation of new structures and the complexity of the group. This should provide the bank with further guidance about ensuring adequate governance and management throughout its operational structure.

Principle 13

Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations. They should also seek to mitigate the risks identified (ie "understand-your-structure").

117. The bank may have legitimate purposes for operating in particular jurisdictions (or with entities or counterparties operating in these jurisdictions) or for establishing certain structures (eg special purpose vehicles or corporate trusts). However, operating in jurisdictions that are not fully transparent or do not meet international banking standards (eg in the areas of prudential supervision, tax, anti-money laundering or anti-terrorism financing),[35] or through complex or non-transparent structures, may pose financial, legal, reputational and other risks to the banking organisation; may impede the ability of the board and senior management to conduct appropriate business oversight; and could hinder effective banking supervision. The bank should evaluate proposed activities and transactions

---

[35] 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.

such as described above and carefully consider, prior to approval, how it will implement effective board and/or managerial oversight.

118. In addition to the risks discussed above, the bank may also be indirectly exposed to risk when it performs certain services or establishes structures on behalf of customers.[36] Examples include acting as a company or partnership formation agent, providing a range of trustee services and developing complex structured finance transactions for customers. While these activities are often profitable and can serve the legitimate business purposes of customers, 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 a bank that provides such services, could cause it to deviate from its core business and could preclude adequate control of the risks posed by the client to the group as a whole.

119. The board and senior management as appropriate should note these challenges and take appropriate action to avoid or mitigate them by:

- maintaining and reviewing, on an ongoing basis, appropriate policies, procedures and strategies governing the approval and maintenance of those structures or activities;
- periodically monitoring such structures and activities to ensure that they remain consistent with their established purpose so that they are not held without adequate justification; and
- establishing adequate procedures to identify and manage all material risks arising from these activities. The bank should only approve these operations if the material financial, legal and reputational risks can be properly identified, assessed and managed.

120. In addition, consistent with guidance from the board, senior management should ensure the bank has appropriate policies and procedures to:

- establish processes for the approval of such activities (eg applicable limits, measures to mitigate legal or reputational risks, and information requirements), taking into account the implications for the resulting operational structure of the organisation;
- define and understand the purpose of such activities, and ensure that the actual exercise of these activities is consistent with their intended purpose;
- document the process of consideration, authorisation and risk management to make this process transparent to auditors and supervisors;
- regularly evaluate the continuing need to operate in certain jurisdictions or through complex structures that reduce transparency;
- ensure that information regarding these activities and associated risks is readily available to the bank's head office, is appropriately reported to the board and supervisors; and
- ensure that these activities are subject to regular internal and external audit reviews.

---

[36] See *Customer Due Diligence for Banks*, Basel Committee on Banking Supervision, October 2001, available at www.bis.org/publ/bcbs85.htm.

121. The board of the parent company can enhance the effectiveness of the above efforts by requiring a control function (such as internal audit, risk management or compliance) to conduct a formal review of the structures, their controls and activities, as well as their consistency with board-approved strategy and report to the board and senior management on its findings.

122. The board should be prepared to discuss with, and report to, the bank's supervisor the policies and strategies adopted regarding the establishment and maintenance of these structures and activities.

F. Disclosure and transparency

Principle 14

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

123. Transparency is essential for sound and effective corporate governance. As emphasised in existing Committee guidance on bank transparency,[37] it is difficult for shareholders, depositors, other relevant stakeholders and market participants to effectively monitor and properly hold accountable the board and senior management when there is insufficient transparency. The objective of transparency in the area of corporate governance is therefore to provide these parties, consistent with national law and supervisory practice, with key information necessary to enable them to judge the effectiveness of the board and senior management in governing the bank.

124. Although transparency may be less detailed for non-listed banks, especially those that are wholly owned, these institutions 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.

125. The bank should disclose relevant and useful information that supports the key areas of corporate governance identified by the Committee (see paragraph 5). Such disclosure should be proportionate to the size, complexity, ownership structure and risk profile of the bank.

126. In general, the bank should apply the disclosure and transparency section of the 2004 OECD principles.[38] Accordingly disclosure should include, but not be limited to, material information on the bank's objectives, governance structures and policies (in particular the content of any corporate governance code or policy and the process by which it is implemented), major share ownership and voting rights and related parties transactions. The bank should appropriately disclose its incentive and compensation policy following the FSB Principles and Standards related to compensation.

127. The bank should also disclose key points concerning its risk tolerance/appetite (without breaching necessary confidentiality), with a description of the process for defining it

[37] See *Enhancing Bank Transparency*, Basel Committee on Banking Supervision, September 1998, available at www.bis.org/publ/bcbs41.htm.

[38] Section V of the 2004 OECD principles state that "The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company". See footnote 3 for reference.

and information concerning the board involvement in such process. When involved in complex or non-transparent structures, the bank should disclose adequate information regarding the purpose, strategies, structures, risks and controls around such activities.

128. Disclosure should be accurate, clear and presented in an understandable manner and in such a way that shareholders, depositors, other relevant stakeholders and market participants can consult it easily. Timely public disclosure is desirable on a bank's public website, in its annual and periodic financial reports or by other appropriate forms. It is good practice that an annual corporate governance-specific and comprehensive statement is in a clearly identifiable section of the annual report depending on the applicable financial reporting framework. All material developments that arise between regular reports should be disclosed without undue delay.

IV. The role of supervisors

129. The board and senior management are primarily responsible and accountable for the governance and performance of the bank and shareholders should hold them accountable for this. A key role of supervisors, then, is to ensure that banks practice good corporate governance to achieve the public policy objectives discussed above in section III. This section sets forth several principles that can assist supervisors in assessing bank corporate governance.

1. Supervisors should provide guidance to banks on expectations for sound corporate governance.

130. Supervisors should establish guidance or rules, consistent with the principles set forth in this document, requiring banks to have robust corporate governance strategies, policies and procedures. This is especially important where national laws, regulations, codes, or listing requirements regarding corporate governance are not sufficiently robust to address the unique corporate governance needs of banks.

2. Supervisors should regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles.

131. Supervisors should have supervisory processes and tools for evaluating a bank's corporate governance policies and practices. Such evaluations may be conducted through on-site inspections and off-site monitoring and should include regular communication with a bank's senior management, board, internal control functions and external auditors.

132. When evaluating individual banks, supervisors should consider 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. Moreover, supervisors should consider the overall characteristics and risks of the banks in their jurisdictions, as well as relevant national factors, such as the legal framework.

133. 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 expect banks to implement organisational structures that include appropriate checks and balances. Regulatory guidance should address, among other things, clear allocation of responsibilities, accountability and transparency.

134. Supervisors should obtain the information they judge necessary to evaluate the expertise and integrity of proposed board members and senior management. The fit and proper criteria should include, but may not be limited to: (1) the contributions that an individual's skills and experience can make to the safe and sound operation of the bank, including general management skills 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 require banks to have in place processes to review how well the board, senior management and control functions are fulfilling their responsibilities. Supervisors are encouraged to meet with individual board members, senior managers and control functions as part of the ongoing supervisory process.

135. Supervisors should evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their oversight responsibilities. In addition to policies and processes, such mechanisms include properly positioned and staffed control functions, such as internal audit, risk management and compliance. In this regard, supervisors should assess the effectiveness of oversight of these functions by the bank's board. This could include assessing the extent to which the board interacts with and meets with the representatives of the control functions. Supervisors should ensure that the internal audit function conducts independent, risk-based and effective audits. This includes conducting periodic reviews of the bank's control functions and of the overall internal controls. Supervisors should assess the adequacy of internal controls that foster sound governance and how well they are being implemented.

136. In reviewing corporate governance in the context of a group structure, supervisors should take into account the corporate governance responsibilities of both the parent company and subsidiaries. In this respect, home and host country supervisory issues may also emerge.

3. Supervisors should supplement their regular evaluation of a bank's corporate governance policies and practices by monitoring a combination of internal reports and prudential reports.

137. Supervisors should obtain information from banks on their corporate governance policies and practices. These should be updated at regular intervals and when significant changes have occurred. Supervisors should collect and analyse information from banks with a frequency commensurate with the nature of the information requested, and the risk profile and significance of a bank.

138. For monitoring and evaluation purposes, the supervisor should periodically review key internal reports of the bank. To make meaningful comparisons between banks, the supervisor may also require a standardised supervisory reporting process, covering the data items the supervisor deems necessary.

4. Supervisors should require effective and timely remedial action by a bank to address material deficiencies in its corporate governance policies and practices, and should have the appropriate tools for this.

139. Supervisors should have a range of tools at their disposal to address material corporate governance deficiencies of a bank, including the authority to compel appropriate remedial action. The choice of tool and the timeframe for any remedial action should be proportionate to the level of risk the deficiency poses to the safety and soundness of the bank or the relevant financial system(s).

140. When a supervisor requires a bank to take remedial action, the supervisor should set a timetable for completion. Supervisors should have escalation procedures in place to require more stringent or accelerated remedial action in the event that a bank does not adequately address the deficiencies identified, or in the case that supervisors deem further action is warranted.

5. Supervisors should cooperate with other relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices. The tools for cooperation can include memorandum of understanding, supervisory colleges and periodic meetings among supervisors.[39]

141. Cooperation and appropriate information-sharing among relevant public authorities, including bank supervisors, central banks, deposit insurance agencies and other regulators, not only for issues related to corporate governance but also more broadly, can significantly contribute to the effectiveness of these authorities in their respective roles. Cooperation can be in a form of supervisory colleges and periodic meetings among supervisors at which corporate governance matters can be discussed. Such communication can help supervisors improve the assessment of the overall governance of a bank and the risks it faces, and help other authorities assess the risks posed to the broader financial system. Information shared should be relevant for supervisory purposes and be provided within the constraints of applicable laws. Special arrangements, such as a memorandum of understanding, may be warranted to govern the sharing of information among supervisors or between supervisors and other authorities.

V. Promoting an environment supportive of sound corporate governance

142. As discussed in this document, the primary responsibility for good corporate governance rests with boards and senior management of banks. In addition, banking supervisors have an important role in developing guidance and assessing bank corporate governance practices. There are also many others (some of which have already been discussed in this document) 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;
- external auditors - through a well-established and qualified audit profession, audit standards and communications to boards, 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;

[39] See *Principles for the Supervision of Banks' Foreign Establishments* (also known as the Basel Concordat), Basel Committee on Banking Supervision, May 1983, available at www.bis.org/publ/bcbsc312.htm and subsequent Basel Committee papers on supervisory cooperation and home-host supervision.

- 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 legitimate concerns regarding illegal, unethical or questionable practices or other corporate governance weaknesses.

143. As noted above, corporate governance can be improved by addressing a number of legal issues, such as:

- protecting and promoting rights of shareholders, depositors and other relevant stakeholders;
- 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, depositors 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.

144. 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.