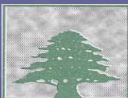

International Standards for Bank Management Governance

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Damascus July 2, 2005

The Basel Committee on Banking Supervision issued a study entitled "Enhancing Corporate Governance for Banking Organisations" in September 1999.

This paper aimed at fostering safe and sound banking practices, by drawing from the collective supervisory experience of its members.

The Basel Committee published this paper to reinforce the importance for banks of the "OECD principles of Corporate Governance" (issued in May 1999)

Enterprise Governance Definition

‘The set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organisation’s resources are used responsibly.’*

* (Information Systems Audit and Control Foundation)

ENTERPRISE GOVERNANCE

Corporate Governance
i.e. Conformance

Business Governance
i.e. Performance

Accountability
Assurance

Value Creation
Resource Utilisation

ENTERPRISE GOVERNANCE

Board of Directors

Executive Management

Corporate Governance Processes

- Chairman/CEO
- Non Executive Directors
- Audit Committee
- Resources and Remuneration Committee
- Risk Management
- Internal Audit

ACCOUNTABILITY

ASSURANCE AUDIT

Business Governance Process

- Strategic Planning and Alignment
- Strategic Decision Making
- Strategic Risk Management
- Scorecards
- Strategic Enterprise Systems
- Continuous Improvement

VALUE CREATION

RESOURCE UTILISATION

OECD Principles for Corporate Governance

The OECD Council declared:

Over the past decade, the world has witnessed a significant transformation in the role of the private sector in economic development. As more and more countries has adopted market – based approaches to economic policy and awareness of the importance of private companies for the welfare of individuals has increased.

Corporations create jobs, generate income, produce a wide range of goods and services and increasingly manage our savings and secure our retirement income. **Amid growing reliance world wide on private sector, the issue of corporate governance has similarly risen in prominence.**

The recent financial crises in Asia also have made clear to other countries all over the world why the issues of transparency and accountability in corporate governance are so important to investor confidence and to overall national economic performance.

Corporate governance relates to the internal means by which corporations are operated and controlled.

While governments play an important role in shaping the legal, institutional and regulatory climate within which individual corporate governance systems are developed, **the main responsibility lies with the private sector.**

A good corporate governance regime helps to assure that companies use their capital efficiently, it also helps to ensure that corporations take into account the interests of the communities within which they operate, and their boards are accountable to the company and the shareholders.

This, helps to assure that corporations operate for the benefit of society as a whole. It helps to maintain the confidence of investors – both foreign and domestic – and to attract more capital.

I. The rights of Shareholders

The corporate governance framework should protect shareholder's rights.

1.1)- Basic shareholder rights include the right to:

- Secure methods of ownership registration.
- Convey or transfer shares.
- Obtain relevant and regular information on the company
- Participate and vote in shareholder meetings.
- Elect members of the board.
- Share in the profits of the corporation.

1.2)- Shareholders should have the right to participate in decisions concerning fundamental company changes.

1.3)- Shareholders should have the opportunity to participate in shareholder meetings and should be informed of the rules,, that govern these meetings.

1.4)- Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

1.5)- Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights

II. The Equitability Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority shareholders.

All shareholders should have the opportunity to obtain effective redress for violation of their rights.

2.1)- All shareholders of the same class should be treated equally.

2.2)- Insider trading and abusive self-dealing should be prohibited.

2.3)- Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation

III. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between the company and its stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.

3.1)- The corporate governance framework should assure that the rights of stakeholders are respected.

3.2)- Where stakeholder interests are protected by law, they should have the opportunity to obtain effective redress for violation of their rights.

3.3)- Where stakeholders participate in the corporate governance process, they should have access to relevant information.

IV. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including its financial situation, performance and management.

4.1)- Disclosure should include, but not be limited to, material information on:

- Financial and operating results.
- Company objectives.
- Major share ownership.
- Members of the board and executives and their remuneration.
- Material foreseeable risk factors.
- Material issues regarding employees and other stakeholders.
- Governance structures and policies.

4.2)- Information should be prepared, audited and disclosed in accordance with high quality standards of accounting.

4.3)- An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been presented.

4.4)- Channels for disseminating information should provide for clear and timely access to relevant information by users.

V. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.

5.1)- Board members should act on a fully informed basis, in good faith and in the best interest of the company.

5.2)- The board should treat all shareholders fairly.

5.3)- The board should ensure compliance with applicable law.

5.4)- The board should fulfill certain key functions, including:

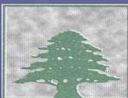
- ❖Reviewing and guiding corporate strategy, risk policy , and business plans.
- ❖ Selecting and compensating key executives.
- ❖Monitoring potential conflicts of interest, including misuse of company's assets and abuse in related party transactions.
- ❖Ensuring the integrity of the company's accounting and reporting systems.
- ❖Overseeing the process of disclosure and communications.

5.5)- The board should be able to exercise objective judgment on corporate affairs independently from management.

The Basel Committee affirmed that:

Banking supervision cannot function if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every bank. Supervisory experience underscores the necessity of having the appropriate levels of accountability and "checks and balances" within each bank.

Sound corporate governance can contribute to a collaborative relationship between bank management and bank supervisors.



Corporate Governance: A System composed of key players

Management
&
Internal Control

Board of
Directors

Audit
Committee

External Auditors

Supervisors

Other Players
(Market Discipline)

I - Bank corporate governance

Banks are a critical component of any economy. They provide financing for enterprises, basic financial services to a large segment of the population and access to payment systems.

Some banks are expected to make credit and liquidity available in difficult market conditions.

From a banking industry perspective, corporate governance involves the manner in which the business of individual institutions are governed by their boards of directors and senior management, affecting how banks:

- Set Corporate objectives (including generating economic returns to owners)
- Run the day- to- day operations
- Consider the interests of stakeholders
- Align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations
- Protect the interests of depositors.

The Basel Committee issued several papers on specific topics relating to Corporate Governance in Banks and Financial Institutions, namely:

- *Principles for the management of interest rate risk (September 1997).*
- *Framework for internal control systems in banking organisations (September 1998).*
- *Enhancing bank transparency (September 1998).*
- *Principles for the management of credit risk (July 1999).*
- *In addition I may mention the study, entitled "Strengthening Compliance through Effective Corporate Governance" of Susan S. Bies, Member of the Board of Governors of the US Fed, published in Washington D.C. in June 11, 2003.*

The papers highlighted the basics of sound Corporate Governance as follows:

- The corporate values, codes of conduct and other standards of appropriate behaviour.
- A well – articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured.
- The clear assignment of responsibilities and decision – making authorities, incorporating a hierarchy of required approvals.
- The establishment of a mechanism for interaction and cooperation among the board of directors, the senior management and the auditors.

- Strong internal control systems, including internal and external audit functions, risk management function and other checks and balances.
- Special monitoring of risk exposures where conflicts of interest are likely to be high, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision- makers within the firm.
- The financial and managerial incentives to act in an appropriate manner offered to senior management and employees in the form of compensation, promotion and other recognition.
- Appropriate information flows internally and to the public.

There are four important forms of oversight that should be included in the structure of any bank in order to ensure the appropriate checks and balances:

- Oversight by the board of directors or supervisory board.
- Oversight by individuals not involved in the day-to-day running of the various business areas.
- Direct line supervision of different business areas.
- Independent risk management and audit functions.

In addition, it is important that key personnel are fit and proper for their jobs.

II – Sound Corporate Governance Practices

2.1)- Establishing strategic objectives and a set of corporate values that are communicated throughout the bank

It is difficult to conduct the activities of an organisation when there are no strategic objectives or guiding corporate values. Therefore, the board should establish the strategies that will direct the ongoing activities of the bank.

2.2)- *Setting and enforcing clear lines of responsibility and accountability throughout the bank.*

Effective boards of directors clearly define the authorities and key responsibilities for themselves as well as senior management.

2.3)- *Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.*

- The board of directors is ultimately responsible for the operations and financial soundness of the bank.
- The board of directors must receive on a timely basis, sufficient information to judge the performance of management.

In a number of countries, bank boards have found it beneficial to establish certain specialised committees including:

- A risk management committee.
- An audit committee.
- A compensation committee.
- A nominations committee.

2.4)- *Ensuring that there is appropriate oversight by senior management*

Senior management is a key component of corporate governance; While the board of directors provides checks and balances to senior managers, similarly, senior managers should assume that oversight role with respect to business line managers. Even in very small banks, key management decisions should be made by more than one person (four eyes principle).

2.5)- *Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function.*

The role of auditors is vital to the corporate governance process.

2.6) – *Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and environment.*

Failure to link incentive compensations to the business strategy can cause or encourage managers to book business based upon volume and/or short-term profitability to the bank with little regard to long-term risk consequences.

2.7) – *Conducting corporate governance in a transparent manner*

It is difficult to hold the board of directors and senior management properly accountable for their actions when there is a lack of transparency. This happens in situations where the stakeholders, market participants and general public do not receive sufficient information on the structure and objectives of the bank.

Consequently, Public disclosure is desirable in the following areas:

- Board structure
- Senior management structure
- Basic organisational structure
- Information about the incentive structure of the bank
- Nature and extent of transactions with affiliates and related parties.

III- The role of Supervisors

3.1)- Supervisors should be aware of the importance of corporate governance and its impact on corporate performance. They should expect banks to implement organisational structures that include the appropriate checks and balances. Regulatory safeguards must emphasis accountability and transparency.

3.2)- A bank's board of directors and senior management are the ultimate responsible for the performance of the bank. As such, supervisors must check to ensure that a bank is being properly governed and bring to management's attention any problems that they detect through their supervisory efforts.

3.3)- When the bank takes risks that it cannot measure or control, supervisors must hold the board of directors accountable and require that corrective measures be taken in a timely manner. Supervisors should be attentive to any warning sign of deterioration in the management of the bank's activities.

3.4)- Sound corporate governance considers the interests of <u>all stakeholders, including depositors</u>, whose interests may not always be recognised. Therefore, it is necessary for supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors.

Important websites:

- www.bis.org
- www.transparency-lebanon.org
- www.conference-board/knowledge/governance.cfm
- www.worldbank.org/html/fpd/privatesector/cg/
- www.transparency.org/knowl_intro.html
- www.weforum.org/site/knowledgenavigator.nsf/content/Corporate+Governance

Thank You

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