



Outline of the Draft **Policy Brief** on the Corporate Governance of Banks in Asia

Motoyuki YUFU

Principal Administrator, OECD

Session 2

Asian Roundtable on Corporate Governance

Bali, Indonesia

8 September 2005

Before we start...

- Your constructive comments/suggestions are welcomed by the end of September

Mail to: motoyuki.yufu@oecd.org

Brief Overview of the *Draft*

Introduction

Part I. The importance of CG of banks & the characteristics of Asian banks

Part II. Main issues/priorities in the CG of Asian banks

1. Fiduciary duties
2. Role of the board
3. Composition of the board
4. Committees of the board
5. Appropriate credit allocation (↔ related-party transactions)
6. Bank holding companies and bank groups
7. Disclosure
8. Bank's autonomy in relation to the state
9. Bank's monitoring of the CG structure of its corporate borrowers
10. Next steps

“Introduction”

- ARCG mandated to establish the Task Force (Seoul, 2004)
- The Task Force includes bank supervisors and securities authorities from Asia and OECD countries in their private capacities
- **Non-binding**, consultative document (a source of reference)
- Does not cover all issues (➡ *OECD Principles, White Paper*)
- Harmonisation with the work of the *Basel Committee*
- Assists bank supervisors, securities regulators, stock exchanges, banking industry associations, and banks
- Listed and **non-listed** banks, **FOBs**, **SOCBs**, and widely held banks
- Applicable to various board structures

Part I. The importance of CG of banks & characteristics of Asian banks

- The importance of CG of banks *differs* from that of other firms;
 1. **Systemic risks to the whole economy** (← credit allocation, payment, etc.)
 2. **Depositors as a stakeholder**
 3. **Unique, inherent risk of insolvency** (← mismatch in asset/liability, highly leveraged business)
 4. **Safety nets**
 5. **Prudential regulation**
- **Characteristics of Asian banks;**
 1. **CG practices vary within Asian region**
 2. **Challenges lie in CG implementation**
 3. **Banks play a dominant role in Asian economy**

Part II. Main issues/priorities for reform in the CG of banks in Asia

- 1. Fiduciary duties**
- 2. Role of the board**
- 3. Composition of the board**
- 4. Committees of the board**
- 5. Appropriate credit allocation preventing abusive related-party transactions**
- 6. Bank holding companies and bank groups**
- 7. Disclosure**
- 8. Bank's autonomy in relation to the state**
- 9. Bank's monitoring of the CG structure of its corporate borrowers**
- 10. Next steps**

PART II - 1 The fiduciary duties of the board members in Asian banks

- **Fiduciary duties to the shareholders;**
 - ➔ **Extremely important to board members of banks.**
- **Banks also have fiduciary duties to depositors;**
 - ➔ **Board members should be deeply aware of this.**
- **Skills, personal abilities (including maintaining “*healthy scepticism*”);**
 - ➔ **Continued training programs**
- **In addition to the above, high ethical standards are needed**

PART II - 2 The roles and functions of the board in Asian banks

Not exhaustive, but some particularly important ones

- **Formulation of strategy and policies**
 1. **developing code of conduct**
 - ← **templates** provided by supervisors or others
 2. **Setting the “tone at the top” by example**
e.g., abstain from voting, etc. when appropriate

- **Creation of structures (clear responsibility/accountability lines and strict internal control systems). e.g.;**
 1. **Evaluate and appoint/remove executives**
 2. **Ensure well-defined decision-making authority**

PART II - 2 The roles and functions of the board in Asian banks (Cont.)

- **In order for the board to fulfil its functions;**
 - 1. Sufficient flows of information (internal & external) and managerial support**
 - 2. Fit and proper tests**
 - 3. Proper evaluation for the board and its individual members
➔ establish a committee**
 - 4. Bank supervisor's checks/corrections on board's activities**

PART II - 3 The composition of the board

- More **independent** directors needed than other firms
- “**Independent**” of;
 1. Management
 2. Controlling shareholders

“Asian countries should continue to refine norms and practices of ‘independent’ directors” (White Paper)
- Separation between the CEO and chairman;
➔ **Independent or, at least, non-executive chairman**

PART II - 4 The committees of the board

Utilise committees, **for instance;**

- The Audit Committee
- The Risk Management Committee
- The “*Governance Committee*” with combined responsibilities;
 - ✓ Nomination, remuneration, succession planning, training, access to managerial support & info., performance evaluation, etc.
- A specialised committee which exclusively monitor/approve related-party transactions (see *Part II-5*)

PART II - 5 Appropriate credit allocation preventing abusive related-party transactions

- **Tighten regulations on **single borrower's limit**;**
 1. **Basel Committee's guideline; within 25% of bank's capital at a maximum**
 2. **Additional limit; within shareholder's capital contribution to the bank**
- **Suggestions of other **firewalls**;**
 1. **Limitation on ownership (e.g., 10%)**
 2. **Voting caps (for certain issues)**
 3. **Prohibition on owners to hold non-financial companies**
- **A specialised committee which almost **exclusively** monitor/approve related-party transactions**

PART II - 5 Appropriate credit allocation preventing abusive related-party transactions (Cont.)

- Basel Committee; “*Transactions with related parties that pose special risks to the bank*” should be reported
 1. Clearly define such transactions (as **minimum criteria**) and implement them
 - ✓ Also require bank boards to monitor and report those transactions which do not fulfil such criteria but are nevertheless materially important
 2. Require banks to **disclose** such transactions
- It might be advisable that *certain specific types of* related-party transactions should be categorically prohibited

PART II – 6 Bank holding companies and groups of companies containing banks

- Banks within bank groups
 - ➔ Their boards should not be lessened their responsibility
- Banks' parent companies
 1. Refrain from intervening in day-to-day operations
 2. Appoint sufficient number of independent directors to the bank board **(as a controlling owner)**
 3. Have sufficient number of independent directors, etc.
 4. Apply fit and proper test
- Legal framework
 1. Bank supervisors need sufficient legal authority to supervise bank groups
 2. Appropriate legal obligations of bank boards & parent boards reflecting whereabouts of real decision-makings

PART II – 7 Disclosure

- In addition to **listed banks, non-listed banks** should also adhere to international accounting standards, etc. where appropriate
- **SOCBs** should be subject to external audit besides state audit
- Problems found regarding listed bank's disclosure should be shared by both;
 1. **Bank supervisors** and
 2. **Securities authorities** (including stock exchanges)

PART II – 8 Bank's autonomy in relation to the state

- Policy-makers should carefully examine the advantages and disadvantages of regulations
- **The state as an owner** should utilise and respect the legal corporate structure of SOCBs
 - ➔ *OECD Guidelines on Corporate Governance of State Owned Enterprises*
- **SOCBs that are going to be privatised;**
e.g., Banks under temporary state-ownership
 - ➔ **should adopt most advanced CG framework available on their privatisation**

PART II – 9 Bank's monitoring of the CG structure of its corporate borrowers

To what extent banks should assess and monitor the CG of their corporate borrowers, and seek to improve it?

- Bank's **assessment** (*ex-ante* of lending) and **monitoring** (*ex-post*);
➔ Should be encouraged (as a critical part of **credit risk management**)
e.g., Covenants regarding borrowers' CG framework

- **Exercising influence** on the CG of corporate borrowers;
➔ May need careful consideration;
 1. Sending bank employees to the boards should be discouraged
 2. Maintaining good CG of banks themselves is the prerequisite for exercising influence

PART II – 10 Next steps

- Bank supervisors, etc. should develop a **template** of CG code for banks
 - Based on the template, banks should be required to develop their CG codes respectively
- Bank supervisors should **rate** the quality of CG of banks
 - ✓ **Methodology**; clearly articulated, giving enough time for banks to prepare
 - provide **incentives** for improving CG of banks
e.g., differentiated deposit insurance premium reflecting such rating