Session III. Policy Brief on CG of Banks in Asia

Outline of the *Policy Brief on Corporate Governance of Banks in Asia* (ARCG Task Force)

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Before we start; The Asian Roundtable on Corporate Governance (ARCG)

- The OECD and the World Bank Group promote five regional Roundtables on CG in the world.
  The Asian Roundtable (ARCG) was established in 1999.

- ARCG comprises policy-makers, regulators, academics, stock exchanges, non-governmental institutions and private-sector bodies from 13 Asian jurisdictions.
  – Bangladesh, China, Hong Kong, India, Indonesia, Malaysia, Pakistan, Singapore, Korea, Chinese Taipei, Thailand, Vietnam

- ARCG participants agreed on the *White Paper on Corporate Governance in Asia (2003)*

http://www.oecd.org/dataoecd/48/55/25778905.pdf

The ARCG Task Force on CG of Banks in Asia

- One of the six priorities of the *White Paper* (2003)

  "*Governments should intensify their efforts to improve the regulation and corporate governance of banks.*"

- ARCG established a Task Force (2004)
  - Both banking supervisors and capital market authorities
  - Experts from both Asian and OECD countries
  - Members participate in their <u>private capacities</u>

- The Task Force developed the *Policy Brief on CG of Banks in Asia* (2006)

Brief Overview of the *Policy Brief*

INTRODUCTION

PART I: Importance of CG of banks and characteristics of Asian banks

PART II: Main issues and priorities

- The **board** and **board members** (II-1, II-2)
- Board's **composition** and **committees** (II-3, II-4)
- **Related party transactions** and **banking groups** (II-5, II-6)
- Bank's **autonomy** in relation to the state (II-8)
- Bank's monitoring of CG of its **corporate borrowers** (II-9)
- Others (**Disclosure** and Next Steps) (II-7, II-10)

"Introduction" of the *Policy Brief*

- Non-binding. Not a detailed prescription for legislation/regulation.
  ➡ Suggests various means and options (a source of reference)

- Not an another international standard
  ➡ Harmonisation with the *Basel Committee's guidance*

- Does not cover every important issue (➡ *OECD Principles, etc.*)

- Assists bank supervisors, securities regulators, stock exchanges, banking industry associations, and banks

- Applicable to listed and non-listed banks, including FOBs, SOCBs

- Applicable to both one-tier and two-tier 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 companies;

1. Amongst others, ***depositors*** as a stakeholder
2. Huge impact on the whole economy
3. Potential risk of bank run
4. Safety nets (weaker monitoring, manager's moral hazard, public funds at stake)
5. Prudential regulation

- Characteristics of Asian banks;

1. CG practices vary within Asian region
2. CG Challenges lie in the implementation
3. Banks play a dominant role in Asian economy

PART II - 1 The responsibilities of individual board members

- Fiduciary duties of banks' board members

➡ Arguably more important than those of other companies; They also include fiduciary duties to depositors. Board members should have high ethical standards

- These duties cannot be discharged without skills, personal abilities (including maintaining "*healthy scepticism*")

➡ Ongoing training programs on integrity and professionalism

PART II - 2 The roles/functions of the board

- Not exhaustive but several key functions -

Rather than being immersed in day-to-day operations…

- Guiding, approving and overseeing strategies/policies.
  For instance, the board should ensure high ethical standard throughout the bank
    - ✓ Code of conduct
    - ✓ Setting the “tone at the top” by example

- Creating clear accountability lines and internal control systems
  1. Evaluation and appointment/removal of executives
  2. Well-defined decision-making authority and internal control
  3. Executives directly accountable to the board regarding specific key functions

PART II - 2 The roles/functions of the board (Cont.)

- In order for the board to fulfil its functions…

1. Sufficient flows of information and managerial support
   - ✓ Access to the staff, its technical expertise and information
   - ✓ Financial resources to obtain advice from external experts
   - ✓ Views of internal and external auditors

2. Fit and proper tests

3. Performance evaluation for the board and its members

   ➡ utilise a committee

4. Banking supervisor's checks/assessment on board's function

PART II - 3 The composition of the board

- Banks are more encouraged to have independent directors than other firms

  "*A sufficient number of non-executive board members capable of exercising independent judgement… (on) the review of relate party transactions*" (OECD Principles)

- "Independent" of;

  1. Management
  2. Controlling shareholders

  "Asian countries should continue to refine norms and practices of 'independent' *directors"* (White Paper)

- Separation between Chairman and CEO;

  ➡ Independent or, at least, non-executive chairman

<u>PART II - 4</u> The committees of the board

Banks boards have found it beneficial to establish certain committees. Several examples are;

- 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.

<u>PART II - 5</u> Preventing abusive related party transactions

Not all related party transactions are harmful but…

- Is the current "firewall" in your jurisdiction sufficient?
  - ✓ Single borrowers limit
  - ✓ (Limiting ownership and voting rights for certain types of vote)

- One of the *options*:

  A specialised committee which mainly monitors and approves related-party transactions

PART II - 5 Preventing abusive related party transactions (Cont.)

- *(Basel Core Principles) "Transactions with related parties that pose special risks to the bank"* should be reported

→ Approaches can be twofold

1. Clearly define such transactions as a minimum list
2. Also require bank boards to monitor and report those transactions which are not on the minimum list but are nevertheless materially important

- Require banks (including non-listed ones where appropriate) to publicly 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 including banks

- Banks within banking groups
  - Bank boards should not be lessened their responsibility
    e.g. independent directors independent of a parent company
- Banks' parent companies
  - Refrain from intervening in banks' day-to-day operations
  - Appoint independent directors to the bank board **(as a controlling owner)**
  - Have a sufficient number of independent directors for their own boards.
  - Fitness and propriety
- Legal framework
  - Banking supervisors need sufficient legal authority to supervise banking groups

PART II – 7 Disclosure

- Efforts on convergence into international standards on accounting, etc. should be encouraged.
- Where appropriate, public disclosure by non-listed banks should be required
- State owned commercial banks (SOCBs) should be subject to annual independent external audit besides state audit
- Problems found regarding listed bank's disclosure should be shared in due course by both;
  1. Banking supervisors, and
  2. Securities regulators and stock exchanges

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

- The state as an owner should utilise and respect the legal corporate structure of SOCBs
  - ✓ Once the state as a shareholder sets the objectives for SOCBs
  - ✓ It should refrain from intervening in SOCBs' day-to-day operations
  - ✓ Instead, the state should make the boards accountable/responsible

    → *OECD Guidelines on CG of SOEs*

- 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/monitor CG of their corporate borrowers, or exercise influence to improve it?

- Regarding CG of their corporate borrowers, banks'

  (i) assessment (*ex-ante* of lending) and

  (ii) monitoring (*ex-post*)

  → should be encouraged as a critical part of credit risk management, and even as a *policy tool* to improve CG practice in a jurisdiction

- Banks' 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 a prerequisite for exercising influence

PART II – 10   Next steps

- Banking supervisors or others should develop a national code of CG specialised for banks (template)

➡ Based on the template, banks should be required to develop their CG codes respectively

- Banking supervisors should provide more incentives for banks to improve CG. *For instance:*
  - Ratings in terms of the quality of CG of banks
  - Differentiated deposit insurance premium reflecting (at least partially) such ratings

Discussion Session

- Discussions in four parts
- Approximately 15 minutes each
- Any views: Your views based on the experiences in your jurisdiction are especially appreciated

Discussion on the *Policy Brief* ***1/4***

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PART II:

- The board and board members (II-1, II-2)
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