The Supervisory Assessment of Corporate Governance

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Agenda

- **The role of supervisors**
- The licensing process
- On-site and off-site supervision practices
- Supervisory follow-up

Why should supervisors care about corporate governance?

- Well run banks are obviously easier to supervise
- Supervisors are not supposed to be running banks
- There should be a natural partnership between bank management and banking supervisors
- Reduces our own vulnerability
- A well-managed financial system contributes to the public good

What is the role of supervisors?

- Supervisors should:
  - expect banks to implement organisational structures that include appropriate checks and balances
  - ensure that boards and senior management of individual banks have in place processes to fulfil their responsibilities
  - hold the board accountable for any problems detected and require timely corrective measures
  - be attentive to any signs of deterioration in management

What is the role of supervisors?

- Supervisors should:
  - Set out minimum standards for individuals holding board and management positions
  - Give clear guidance on the specific responsibilities of the board (e.g., oversight, policy-setting, audit, setting of limits)
  - Establish minimum frequency of board meetings and attendance
  - Address possibility of occasional meetings between the board and supervisors

What should be prohibited?

- Conflicts of interest
- Insider trading or dealing
- Connected lending where credit analysis does not support the exposure (must be an “arm’s-length” transaction)

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Why is the licensing process critical?

- First opportunity to assess
  - the corporate structure
  - the board of directors
  - the senior management
- Supervisors should have the ability to deny a licence to a bank that has apparent weaknesses in the corporate governance structure

The licensing process

- Clear and objective criteria reduce the potential for political interference in the licensing process
- "Fit and proper" tests should be used to determine the suitability of proposed directors and senior managers
- Numerous factors to consider
  - formal qualifications
  - previous experience
  - track record

The licensing process

- This formal process should also be applied going forward for changes in control of a bank
- “Fit and proper” tests should be applied to any new proposed owners over a defined threshold

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Supervisory review process

- Traditional methods for monitoring corporate governance:
  - On-site examinations
  - Off-site surveillance
  - Periodic meetings with bank management
  - Review of work of internal and external auditors
  - Periodic reporting
- Supervisory follow-up

Objectives of on-site examinations

- To determine whether the board of directors fully understands its duties and responsibilities and has developed adequate objectives and policies
- To determine if the board is discharging its responsibilities in an appropriate manner
- To determine whether the board has developed adequate policies
- To determine the existence of any conflicts of interest
- To determine compliance with laws and regulations

Objectives of on-site examinations

- To evaluate management experience and depth
- To determine the adequacy and consistency of written objectives, policies and procedures, and to determine that they are being adhered to
- To determine that management adequately plans for future conditions and developments
- To evaluate the adequacy of personnel practices as they relate to management continuity
- To evaluate the soundness of management decisions

On-site examinations – Board review

- Review the policies approved by the Board and determine that they cover the major areas and activities of the bank
- Obtain a complete set of the latest reports given to the Board and determine that they are sufficient and accurate
- Determine whether conflicts of interest exist
- Review the minutes of Board meetings since the last exam and any supporting documents/reports
- Determine the Board’s oversight of senior management

On-site examinations – management review

- Obtain and review the following:
  - an organisation chart
  - administrative and personnel manuals
  - marketing/business plan
  - resumés of all executive officers and department heads
  - a list of salaries paid to executive officers and salary ranges for other key staff
  - a description of other employee benefits
  - daily and periodic reports submitted to management

On-site examinations

- Supervisors should review:
  - risk management processes
  - adherence to set limits (and filing/treatment of exception reports)
  - management information systems
  - internal control systems
  - internal audit reports and follow-up
  - external audit reports and follow-up

On-site examinations - results

- Supervisors should ensure that all directors are aware of key findings of examinations
- Supervisors should meet with the Board of Directors to review examination findings, especially when there are problems
- In addition, they should consider supplying the directors with a summary report highlighting any significant problems or areas of concern

Meetings with Board of Directors

- Objectives are to:
  - foster a better understanding of the respective roles of directors and examiners
  - inform directors of the examination scope and the bank's condition
  - obtain information concerning future plans and proposed changes in policies that may have a significant impact on the future condition of the bank
  - obtain a commitment to initiate appropriate corrective action for any problems

Off-site surveillance

- Ongoing off-site surveillance has the objective of identifying important issues at an early stage so that appropriate action is taken before major problems develop
- Supervisors should establish a principle that supervised institutions keep the supervisors informed of important issues on a timely basis (no surprises!)

Off-site surveillance

- Supervisors should monitor:
  - overall financial condition of the bank, looking for signs of deterioration
  - reports filed on specific matters (large exposures, connected lending, etc)
  - follow-up by management to weaknesses detected during the examination process
  - changes in board, senior management and shareholders (over a certain percentage)

Periodic meetings with bank management

- Supervisors should discuss:
  - overall strategy of the bank
  - any planned changes to activities/major acquisitions or divestitures
  - any deterioration in the bank's overall condition
  - any changes to board composition or senior management
  - management succession plan

Review of work done by internal and external auditors

- Supervisors should evaluate the work of the internal audit department and, if satisfied, can rely on it to identify control problems or areas of potential risk
- Supervisors should discuss with the internal auditors the risk areas identified and corrective measures taken
- Whenever the head of internal audit is replaced, the supervisor should be informed by management

Review of work done by internal and external auditors

- Supervisors and external auditors have similar concerns regarding the activities of banks
- The supervisor should make use of work conducted by the external auditor, as appropriate
- The supervisory should also be made aware of any serious problems detected by external auditors

Review of work done by internal and external auditors

- Work performed for the supervisor by the external auditor should have a legal or contractual basis
- The contract should address confidentiality
- External auditor’s work for the supervisor must be complementary to regular audit work

Review of work done by internal and external auditors

- Supervisors should:
  - review management reaction/follow-up to weaknesses detected by internal and external auditors
  - ensure that internal auditors report directly to the board or its audit committee
  - determine that there are no conflicts of interest

Periodic reporting

- Supervisors should require periodic reports on:
  - large exposures
  - connected lending
  - what else?

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Supervisory follow-up

- When corporate governance at a particular bank is deemed to be insufficient or ineffective, supervisors must ensure that corrective actions are taken promptly
- There is no room for supervisory “forbearance” when it comes to weaknesses in the governance of a banking institution

Supervisory follow-up

- Possible supervisory actions include:
  - Mild (extra reporting, special exams/audits, etc.)
  - More punitive (fines, replacement of managers/board members, suspension of dividends)
  - Assignment of trustee/overseer
  - Revocation of licence
- It is critical that each member of the Board of Directors understands his/her responsibility for ensuring that proper corrective actions are taken

Questions or Comments?

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