Corporate Governance in the Banking Sector:
Issues & Challenges

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Why Corporate Governance Is a Hot Topic

- Enron
- Allied Irish Bank
- Worldcom
- Sarbanes-Oxley
The Purpose of Corporate Governance

- To build and strengthen
  - Accountability
  - Credibility
  - Transparency
  - Integrity
  - Trust

"And this is our department of experimental accounting."
Good Governance Protects:

- Shareholders
- Employees
- Customers
- Public
- Supervisors
Corporate Governance Defined

Two Simple But Useful Definitions

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

OECD

“Corporate governance is the system by which companies are directed and controlled.”

Cadbury Report, 1992
Another View of Corporate Governance

A system whereby...

- Shareholders who own the company...
- Appoint, or elect directors to monitor and protect their interests in the company; these directors...
- Retain independent auditors to validate the financial results produced by the company; these results...
- Serve as a report card on the performance of the directors and management
To function effectively, all the parts must work, and all the parts must work together.
Corporate Governance
- Sources of Influence -

- Governments, through laws
- Securities regulators/stock exchanges
- Industry associations
- Auditors
- Market participants
- Supervisors
Influence Mechanisms

- Assignment of decision-making powers
- Articulating corporate strategy
- Providing checks and balances
- Monitoring potential conflicts of interest
- Developing an incentive structure
- Fostering interaction between board and senior management
- Providing an audit structure
- Setting corporate values and standards
Recent Work on Corporate Governance

- OECD
- The IMF and World Bank
- Basel Committee on Banking Supervision
- The Joint Forum
- Many national authorities
The Basel Guidelines

- Document issued in 1999
- Sets out the key elements of corporate governance
- Focused on the unique issues related to corporate governance of banks
- Intended as a supplement to OECD guidance
- Document does not promote a particular governance structure (e.g., unitary board)
Basel Guideline #1
Establish strategic objectives and corporate values

- The board should:
  - establish strategic objectives and corporate values and have them communicated throughout the bank
  - ensure that senior management implements policies that prohibit/limit activities and relationships that diminish governance (e.g., conflicts of interest)
  - establish processes to monitor compliance with these policies
  - see that corporate ethics are observed
Basel Guideline #2
Set and enforce clear lines of responsibility and accountability

- The competencies and key responsibilities for the board and senior management should be clearly defined to ensure their effectiveness.

- Senior management is responsible for creating an accountability hierarchy for the staff, but it remains ultimately responsible to the board for overall performance.
 Basel Guideline #3

Board members should be qualified, understand their role, and not be subject to undue influence from management or outside concerns

- The board is ultimately responsible for the operations and financial soundness of the bank
- The board should have an effective number of qualified and independent directors to provide sufficient checks and balances
- The board should not participate in day-to-day management but should receive information sufficient to judge management
- It is beneficial to establish certain specialized committees to assist the board in its oversight function
Board Structure

- **Composition**
  - A significant number of board members should be independent
  - The board members should reflect industry and governance expertise
  - Board members should have the ability and willingness to question and challenge management
  - Independent directors should not serve for a protracted time period
Board Committees

- Board Committees should:
  - each have a formal charter approved by the full Board
  - meet regularly based on a formal schedule
  - keep written minutes for all committee meetings
  - have these minutes formally reviewed, approved and retained as permanent records
Board Committees

- Possible Board Committees:
  - Audit/Examination (now a “must” for most banks)
  - Compensation
  - Nominating
  - Loan
  - Risk Management
  - Investment
  - Asset/Liability
Audit Committee

- Ensures an adequate system of internal controls
- Supervises and controls the internal audit function
- Reviews activity reports from internal audit
- Ensures comprehensive coverage between internal and external audit
- Head of internal audit should report directly to the Board of Directors or its audit committee in order to ensure independence from management
Audit Committee

- Responsible for recommending to the Board the hiring (and firing) of the external audit firm and overseeing the organization’s relationship with the firm
- Supervises the review and approval of public financial statements
- Comprised of the more financially literate board members (chairman should have expertise in accounting or financial management)
- Typically comprised of non-executive members only (a requirement in many countries)
Basel Guideline #4
There should be appropriate oversight by senior management

- Senior management should assume an oversight role with respect to line managers in specific business areas and activities.
- Senior managers should have the necessary skills to manage the business under their oversight and have appropriate control over the key individuals in these areas.
- Senior managers should be careful to exercise control over successful, key employees (such as traders), even at the risk of losing them.
Basel Guideline #5

The work conducted by internal and external auditors should be effectively utilized

- The effectiveness of board and senior management can be enhanced by:
  - Requiring the head of audit to report directly to the board of directors or its audit committee
  - Taking measures to ensure the independence and stature of auditors
  - Engaging external auditors to judge the effectiveness of internal controls
  - Requiring timely correction of identified problems
  - Recognizing the importance of the audit process
External Audits

- Potential conflicts of interest can be minimized by placing restrictions on the consulting work that can be done for a firm’s audit clients.

- Rotation of audit firms or partners:
  - Since March 2002, MAS requires all banks incorporated in Singapore to change audit firms every five years.
  - External auditor is appointed by the Reserve Bank of South Africa.
  - UK FSA is considering the requirement that audit contracts be put out for bid on a regular basis (while not barring current auditors from being reappointed).
Basel Guideline #6

Compensation approaches should be consistent with the bank’s ethical values, objectives, strategy and control environment

- The board should approve compensation of senior management and other key personnel
- Failure to link incentive compensations to business strategy may encourage booking of business based on volume/short-term profitability with little regard to risk consequences
- Salary scales should be set within the scope of general business policy in such a way that they do not overly depend on short-term performance (e.g., short-term trading gains) to discourage excessive risk-taking
 Basel Guideline #7
Corporate governance should be conducted in a transparent manner

- Transparency can reinforce sound corporate governance and enable a bank’s stakeholders and the general public to judge the effectiveness of its board and senior management
- Directors and senior management are thus made more accountable for their actions and performance
Public Disclosure Recommended
For:

- Ownership structure
- Board membership and responsibilities
- Compensation and equity interests of owners and managers
- Role and activities of the bank
- Responsibility for strategic direction
- Audit procedures (internal and external)
Corporate Governance
- Why Supervisors Care -

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

Supervisors should:

- Expect banks to implement organizational structures that include appropriate checks and balances
- Ensure that boards and senior management of individual banks have in place processes to fulfill their responsibilities
- Hold the board accountable for any problems detected and require timely corrective measures
- Be attentive to any signs of deterioration in management
- Consider issuing guidance to banks on sound corporate governance
Corporate Governance
- Consider Context -

- Impossible to legislate integrity
- “Independence” difficult to define
- Substance over form
- Leadership: board members and senior management as true role models
Sarbanes-Oxley Act
- Background -

- Signed into law in July 2002 after a series of corporate scandals
- Enhance corporate governance by improving board/audit independence and corporate disclosure
- Applies to all publicly traded banking institutions, including foreign banks
- Regulators to provide interagency guidance
Sarbanes-Oxley Act
- New Rules on Audit Committee -

- All audit committee members must be independent
  - “not receiving, other than for service on the board, any consulting, advisory or other compensatory fee from the issuer [bank/BHC], and as not being an affiliated person of the issuer [bank/BHC], or any other subsidiary thereof”

- Affiliated persons – any party that owns more than 5 percent of the company

- If no audit committee, full board can perform that function if all members are independent

- Must disclose whether at least one member is “audit committee financial expert,” and if not, the reason why not
Sarbanes-Oxley Act
- New Rules on Audit Committee -

- Audit committee to select external auditors and approve other non-audit services
- Must have resources to engage independent advisors
- Must set-up mechanisms for “whistle-blowing”
Sarbanes-Oxley Act
- New Rules on Auditor Independence -

- New rules on audit partner rotation
- New restrictions on employment of audit firm personnel
- Banned a number of non-audit services
Sarbanes-Oxley Act
- List of Prohibited Non-Audit Services -

- Booking
- Financial information systems design/implementation
- Appraisal/valuation services
- Internal audit outsourcing
- Management/human resources
- Broker-dealer, adviser, investment banking
- Legal/expert services
U.S. Corporate Governance
- Some Numbers -

- 80% Portion of NYSE companies with board nominating committee (changing to governance committee?)
- 75% Portion of S&P 500 companies with combined CEO/Chairman (changing?)
- 33% Portion of U.S. boards that formally assess their performance
- 14 Average number of hours that directors spend on board matters per month (preparation, meetings, travel)
- 11 Average size of U.S. board

Source: Korn/Ferry survey 2002 (boardmember.com), NY Fed survey of 37 banks
Questions
Resources

- “Enhancing Corporate Governance for Banking Organisations,” Basel Committee on Banking Supervision, July 2005
- “Principles of Corporate Governance,” Organization for Economic Co-operation and Development, 2004
- Institute of Chartered Accountants (UK) – “Internal Control: Guidance for Directors on the Combined Code,” September 1999
Resources

- http://www.oecd.org
- http://www.bis.org