Governance Wake-up Call for Bank Directors

By Gregory Wilson

With little public fanfare, the Basel Committee on Bank Supervision of the Bank for International Settlements (BIS) recently announced eight newly enhanced corporate governance principles for banking organizations, including their parent companies.[1] Both bank directors and managers are confronted with yet another set of new, detailed norms to govern banks.

These new bank governance principles have raised the stakes for bank directors everywhere. Simply showing up at board and committee meetings and being well informed is only half the battle - establishing clear governance polices, effective processes, and embedding good governance into everyday banking practice is the other half. This is especially true in the future, since bank directors effectively are being asked by national supervisors in multiple jurisdictions to certify that good governance is fully in place at all of their banks for all the right reasons.

Fortunately, the value of good governance in banks increasingly demanded by investors is now clearly recognized by both management and their overseers (boards and supervisors). For boards and management, good governance means higher stock valuations, better performance, and better relations with regulators, many of whom increasingly embrace performance-based regulation in practice. For regulators and national leaders, it means better risk management, fewer problems that could affect depositor protection or systemic stability, and stronger banking systems to support economic growth.

These governance principles are just the other side of the global banking industry's newly minted risk management coin: if the latest Basel II framework for capital adequacy[2] is the obverse, then these principles are the reverse. As with any coin of

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[1] Basel Committee on Banking Supervision, Bank for International Settlements, *Enhancing Corporate Governance for Banking Organizations* (February 2006).

[2] Basel Committee on Banking Supervision, Bank for International Settlements, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (November 2005).

any realm, bank directors in particular will need to understand not only what stands behind its store of value but also how it can be saved or spent along with other currency they have with their regulators.

Bank directors - especially non-executive directors who may not be financial experts – need to understand the full implications of these new Basel principles. And while all 22 pages are worth reading, several principles will have more impact and frankly cause more anguish for directors, especially when applied differently by local regulators.

IN DEVELOPED BANKING MARKETS

Two of the new principles require special attention by bank directors in the developed world.

Principle 3. The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization. Sounds like common sense and accepted practice. Directors, however, need to understand two points of detail.

First, banks part of larger groups present unique challenges for both boards and regulators, especially if a bank is challenged supervisorily. As markets continue to globalize and host country policy pressures increase for more local bank subsidiaries – not just branches – with local boards and local listings, a potential collision point lies ahead. "The board of the subsidiary bank retains its corporate governance responsibilities for the bank itself, including the soundness of the bank and the protection of the interests of depositors . . . " This will be a significant challenge for group governance if the interests of the bank and the group diverge, for example, during a financial crisis.

Second, while the same principle also recognizes the increasing trend of parent-level matrix and business line management that may not coincide with legal entity structures, special caution is needed where there may be gaps in responsibility and accounting for operating subs. "In such cases, the bank's board, senior management, and internal control functions should ensure that decisions of such matrix and business line management structures are consistent with proper fulfillment of corporate governance responsibilities at the group and bank level." In other words, bank management must be able to explain and defend matrix organizations and risk management structures to the satisfaction of their supervisors.

Principle 3 also goes hand in hand with Principle 8.

Principle 8. The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i.e., "know-your-structure"). This principle speaks directly to some of the well known governance failings in recent years affecting corporations and banks alike that used special purpose vehicles, corporate trusts, or offshore financial centers. While this may not lead to Sarbanes-Oxley II, bank supervisors have plenty of discretion.

Acknowledging that such practices may often be legitimate and appropriate, the days of opaque structures for core businesses and clients is over – transparency is the new sheriff in town. New documentation requirements by directors are explicit: "*The board of directors, or senior management under the direction of the board, should document this [know-your-structure] process* of consideration, authorization, and risk management to make the process transparent to auditors and supervisors (*emphasis added*)."

Both of these principles tie into one of the six unnumbered supervisory principles in the new Basel guidance: "Supervisors should evaluate the effects of the bank's group structure." This admonition applies especially for internationally active banks, and there is encouragement for countries to change their laws to enhance transparency and information sharing regimes between home-host country supervisors where needed.

IN EMERGING MARKETS AND TRANSITION ECONOMIES

One particular principle has a heightened sense of urgency for bank directors in emerging markets where corporate governance as a concept and practice is still evolving. Parts of at least three other principles, when read together, also have new implications for directors of state-owned banks.

Principle 7. The bank should be governed in a transparent manner. No surprise that transparency goes hand-in-hand with good governance. We live in a world, however, where there is no globally accepted, single set of bank transparency rules for investors, rating agencies, and bank supervisors alike. So bank supervisors in every country have a free hand to impose new disclosure rules with Basel's blessing. Bank directors – especially those in opaque markets - can expect the rules to change, in some countries drastically, which in turn may affect their directorships in the future. A few examples of the more detailed disclosure standards include:

- Board structure, including director selection, qualifications criteria, and independence;

- Basic ownership structure, including major share ownership and voting rights, beneficial owners, and major shareholder participation on the board or in senior management;
- Incentive structures, including director compensation and remuneration policies; and
- Conflicts policy, including where directors have material interests directly in the bank or group, or through third-parties.

State-owned banks. While no single rule applies specifically to state-owned banks, a string of guidance buried in other principles needs to be considered by both state bank directors and policy makers in countries where state banks are a large part of the financial system (e.g., in China, India, Indonesia, Russia, Saudi Arabia, Argentina, and Brasil to name a few). A few of the most important directives to avoid obvious conflicts include:

- Principle 1 – Board members: ". . . The Government should not be in the business of day-to-day management of the bank, the independence of the board should be respected, and the board should continue to have responsibilities independent of political influence . . . ." In other words, state-owned banks should be professionally managed in line with best practices in the private sector.
- Principle 2 – Board approval of strategy: "There should be full administrative separation of the ownership and banking supervision functions . . . ." In other words, state-owned banks should be supervised and examined just like any other bank.
- Principle 7 – Transparency: "Where a bank is state-owned, an ownership policy [should define] the overall objectives of state ownership, the state's role in governance of the bank, and how it will implement its ownership policy." In other words, the state's role should be clearly defined and published to prevent political intervention and favoritism in lending and other decisions that affect the bank's performance.

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