Corporate Governance

USAID-Funded Economic Governance II Project

Presented To: Banking Supervision Department of the Central Bank of Iraq
Date: May 2006

Learning Objectives

At the end of this module, participants will be able to:

- **Explain** the concept of corporate governance
- **Discuss** the importance of corporate governance in the banking industry
- **List** the strategies and techniques that are fundamental to good corporate governance practices
- **Explain** the four important forms of oversight that should be included in the organizational structure of any bank to ensure appropriate checks and balances.
- **Understand** the importance of Bank Supervision in the Corporate Governance implementation process for the banking sector.

Organizational Definitions

- OECD – Organization for Economic Co-operation and Development
- BCBS - Basel Committee on Banking Supervision
- ICGN – International Corporate Governance Network

Overview

What is corporate governance?

Many definitions exist.

WHAT DO YOU THINK SHOULD BE INCLUDED IN THE DEFINITION??

Corporate Governance

Corporate governance refers to the combination of legislation and practice that reflects the way a corporation or joint stock company should be organized and managed, and how it relates to its shareholders, who are the owners of the business.

Corporate Governance

The OECD describes corporate governance as involving

"a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the corporation are set, and the means of attaining those objectives and monitoring performance are determined."

Both ICGN and BCBS concur with the OECD definitions and principles.

Corporate Governance

Ira M. Millstein, Senior Associate Dean for Corporate Governance and Performance at Yale University School of Management and one of the leading corporate governance experts in the USA, wrote:

"…corporate governance is the mechanism through which managers are selected, compensated, monitored, and held to their tasks by boards on behalf of the owners…"

Corporate Governance

Russia –

from the Corporate Governance Code of the Russian Institute of Directors

“Corporate governance” is a term that encompasses a variety of activities connected with the management of companies. Corporate governance affects the performance of economic entities and their ability to attract the capital required for economic growth.

Corporate Governance

Bulgaria –

from a draft work on corporate governance for Bulgarian companies

Corporate governance is a mixture of compliance with the legal framework governing joint stock companies and application of internationally recognized standards for honesty and fair dealing in the management of a public company.

Corporate governance is about creating an effective, transparent and fair relationship between shareholders – the true owners of the company – and the corporate board – the persons elected by shareholders to manage the company.

Corporate Governance

Essentially – Corporate Governance means,

"oversight of a company's management – ensuring that the business is run well and that investors are treated fairly."

Corporate Governance

***The goal of corporate governance*:**

“Ensure that the corporation is always acting with integrity and transparency with financial reporting, that it is honest in its dealing with the public, customers, shareholders, and suppliers…”

Corporate Governance

Why is corporate governance important?

Corporate governance is important because certain practices for how a corporation is formed, owned, organized, and managed are standards of international financial practice.

If companies are to be accepted by international financial managers as parties to commercial transactions and as potential investments or joint venture partners, they must conform to internationally accepted standards.

Corporate Governance

OECD Principles of Corporate Governance are:

- The international benchmark for policy makers, investors, corporations and other stakeholders worldwide
- Endorsed by OECD ministers in 1999
- Principles having been revised and updated in 2004
- Basis for Corporate Governance component of World Bank/IMF Reports on Observance of Standards and Codes (ROSC)

Corporate Governance

The OECD principles have been devised with four fundamental concepts in mind:

1. **Responsibility**
2. **Accountability**
3. **Fairness**
4. **Transparency**

Corporate Governance

OECD has developed <u>six</u> primary principles with each having a number of sub-principles for a total of 32 sub-principles.

1. **<u>Ensuring the Basis for an Effective Corporate Governance Framework</u> – the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. (Four sub-principles)**

2. **<u>The Rights of Shareholders and Key Ownership Functions</u> – the corporate governance framework should protect and facilitate the exercise of shareholder's rights. (Seven sub-principles)**

Corporate Governance

OECD Principles continued

3. **The Equitable Treatment of Shareholders – the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. (Three sub-principles)**

4. **The Role of Stakeholders in Corporate Governance – the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. (Six sub-principles)**

Corporate Governance

BearingPoint

OECD Principles continued

5. **<u>Disclosure and Transparency</u> – the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. (Six sub-principles)**

6. **<u>The Responsibilities of the Board</u> – the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders. (Six sub-principles)**

Corporate Governance

What constitutes good corporate governance practices?

According to the OECD's principles of corporate governance, the corporation should:

- **Protect the rights of shareholders**
- **Ensure the equitable treatment of all shareholders**
- **Ensure that timely and accurate information about the company is disclosed**
- **Ensure effective monitoring of the company by the managing body**
- **Ensure the managing body's accountability to the company and the shareholders**

Corporate Governance

Banks are extremely important to an economy as they provide:

- **Basic financial services to a large segment of the population**
- **Financing to commercial enterprises**
- **Access to payment systems**
- **International transaction processing**
- **Financial intermediary activity**

Corporate Governance

Corporate Governance in the Banking Industry

Banks are critical to the effective performance of any economy.

Without a fully functioning and healthy banking sector, no economy can reach its potential because of the crucial financial intermediary role that banks play in the economy.

Corporate Governance

The importance of the banking sector in the economy is underscored by the fact that banking is a regulated industry in almost every country and banks generally enjoy government support when they encounter financial difficulty.

Given the importance of banks in the economy, it is critical that banks implement and adhere to corporate governance practices that meet international standards.

In the banking industry, corporate governance entails the manner in which banking institutions are governed by their boards of directors and senior management.

Corporate Governance

The BCBS document,"Enhancing Corporate Governance for Banking Organizations" (February 2006), outlines that bank management should:

- **Set corporate objectives**
- **Run the day-to-day operations of the bank**
- **Consider the interests of recognized stakeholders**
- **Align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations, and**
- **Protect the interests of depositors**

Corporate Governance

It is clear that boards of directors and senior management are accountable not only for strategies and policies but also for the daily operations of their banking institution.

And, furthermore, they must acknowledge the interests of all stakeholders, including depositors, as they operate and manage the banking institution in a safe and sound manner within the framework of local laws and regulations.

How well they do this is the essence of corporate governance.

Corporate Governance

Banking is the business of identifying, evaluating, accepting, and monitoring risk - from credit, liquidity and exchange rate risk to interest rate and operational risk - while generating a profit for a positive return to shareholders.

Therefore, high skill and competence is required of all employees engaged in risk-related activities, as well as the ability and capacity of senior management to manage and control these activities within the framework provided by the policies and procedures adopted by the board of directors.

Corporate Governance

Basel Committee on Bank Supervision

The Basel Committee on Bank Supervision has issued a number of papers on a variety of topics in which corporate governance is emphasized.

These papers have stressed strategies and techniques that are fundamental to sound corporate governance.

Corporate Governance

These strategies and techniques include:

- **The corporate values, codes of conduct and other standards of appropriate behavior, and the systems used to ensure compliance with them**
- **A clear corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured**
- **The clear assignment of responsibilities and decision-making authorities, incorporating a hierarchy of required approvals from individuals to the board of directors**
- **Establishment of a mechanism for the interaction and cooperation among the board of directors, senior management and the auditors**

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- Strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances.
- Special monitoring of risk exposures where conflicts of interest are likely to be particularly evident, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the firm
- The financial and managerial incentives to act in an appropriate manner offered to senior management, business line management and employees in the form of compensation, promotion and other recognition, and
- Appropriate information flows internally and to the public.

Corporate Governance

Specifically, the BCBS Corporate Governance document outlines Sound Corporate Governance Principles which are:

1. *<u>Board members</u>* should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
2. The *<u>board of directors</u>* should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization.
3. The *<u>board of directors</u>* should set and enforce clear lines of responsibility and accountability throughout the organization.
4. The *<u>board</u>* should ensure that there is appropriate oversight by senior management consistent with board policy.

Corporate Governance

BCBS Corporate Governance Principles continued:

5. The b<u>*oard and senior management*</u> should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions.
6. The <u>*board*</u> should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.
7. The bank should be governed in a transparent manner.
8. The <u>*board and senior management*</u> 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").

Corporate Governance

In a regulated Banking environment, Banking Supervisors play a key role in promoting strong corporate governance by reviewing and evaluating a bank's implementation of the sound principles set forth by the BCBS.

The BCBS Corporate Governance document provides a series of Bank Supervision principles:

1. **Supervisors** should provide guidance to banks on sound corporate governance and the pro-active practices that should be in place.
2. **Supervisors** should consider corporate governance as one element of depositor protection.

Corporate Governance

BCBS Bank Supervision Principles continued:

- **<u>Supervisors</u>** should determine whether the bank has adopted and effectively implemented sound corporate governance policies and practices.
- **<u>Supervisors</u>** should assess the quality of banks' audit and control functions.
- **<u>Supervisors</u>** should evaluate the effects of the bank's group structure.
- **<u>Supervisors</u>** should bring to the board of directors' and management's attention problems that they detect through their supervisory efforts.

Summary

Good corporate governance is about creating an effective, transparent and fair relationship between shareholders, stakeholders and the corporate board.

In the banking sector, good corporate governance must also include operating in a safe and sound manner, compliance with applicable laws and regulations, and the protection of the interests of depositors.

Effective corporate governance is especially important in the banking industry because of the industry's vital role in the economy as a financial intermediary.

Bank Supervision plays a key role in promoting good corporate governance in the banking industry.

Review of Learning Objectives

Are you able to:

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- **Discuss** the importance of corporate governance in the banking industry?
- **List** the strategies and techniques that are fundamental to good corporate governance practices?
- **Explain** the four important forms of oversight that should be included in the organizational structure of any bank to ensure appropriate checks and balances?

Corporate Governance

Sources:

Wall Street Journal, **October 27, 2003, pp. R6-7**

Corporate Governance, Robert A.G. Monks and Nell Minow, 1995, Blackwell Publishers

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