CORPORATE GOVERNANCE: BEST INTERNATIONAL PRACTICES

PREPARED FOR THE NATIONAL BANK OF ANGOLA

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I. STRENGTHENING FINANCIAL SYSTEMS IN COUNTRIES AROUND THE WORLD

Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The need to improve the strength of financial systems has attracted growing international concern such that a number of official bodies, including the Basle Committee on Banking Supervision of the Bank for International Settlements, the International Monetary Fund, the World Bank and the International Finance Corporation, have focused on examining ways to strengthen financial stability throughout the world.

The Basle Committee on Banking Supervision prepared a comprehensive set of **Core Principles** for effective supervision of financial institutions. The Basle Core Principles[1] are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally. There are twenty-five basic principles that need to be in place for a supervisory system to be effective. The principles relate to:

- Precondition for effective banking supervision – Principle 1;
- Licensing and structure – Principles 2 through 5;
- Prudential regulations and requirements – Principles 6 through 15;
- Methods of ongoing banking supervision – Principles 16 through 20;
- Information requirements – Principle 21;
- Formal powers of supervisors – Principle 22; and
- Cross-border banking – Principles 23 through 25.

In particular, Principles 13, 14, and 15 pertain to aspects of Corporate Governance.

- **Principle 13:** Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.
- **Principle 14:** Banking supervisors must determine that banks have to place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
- **Principle 15:** Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

II. EFFECTIVE SUPERVISION OF FINANCIAL INSTITUTIONS IN ANGOLA

Like most banking laws in countries around the world, Angola's Financial Institutions Act, Law nr. 13/2005, September 30, places the ultimate responsibility for the financial institution's affairs on the Board of Directors. According to this legislation, the Board is answerable to depositors and shareholders

[1] Basle Committee on Banking Supervision, Core Principles for Effective Banking Supervision, Basle, September 1997.

for the safeguarding of their interests through the lawful, informed, efficient and able administration of the institution. The members of the Board usually delegate the day-to-day management of banking business to officers and employees, but cannot abdicate responsibility for the consequences of unsound or imprudent policies and practices related to lending, investing, protecting against internal fraud, or any other banking activity. This approach is consistent with the Bank for International Settlement's **Core Principles for Effective Banking Supervision**.[2]

The most important duty of the board is to ensure that the management team has the necessary skills, knowledge, experience, and good judgment to manage the bank's affairs in a sound and responsible manner. The management should be directly accountable to the Board. There should be adequate internal audit arrangements in place and a risk management system that is applied at all times. Directors need not be experts in these control and audit mechanisms, but they should consult experts within and, if necessary, outside the bank to ascertain that such arrangements are robust and properly implemented.

The board should also ensure that the bank is in compliance with relevant laws and regulations and that no conflict of interest or self-serving practices exist. A self-serving board is a dangerous board. When decisions involve a conflict of interest, the director in question should fully disclose the nature of the conflict and abstain from voting on the matter.

Other self-serving practices of which supervisors and analysts should be aware include the use of a financial institution's credit potential by directors, officers, or shareholders to obtain loans or to transact other business. The issuance of unwarranted loans to a bank's directors or to their business interests is a serious matter from the standpoints of both credit and management. Losses that develop from such unwarranted loans are bad enough, but the weakening effect on the financial institution's general credit culture is likely to be even worse. Attention should also be paid to possible gratuities being given to directors for the purpose of obtaining their approval of financing arrangements or of the use of particular services.

III-A. MANAGEMENT ASSESSMENT

Management appraisal is the assessment of the effectiveness and efficiency of top management in the performance of the financial institution. Such an assessment represents a judgment passed on those individuals running the financial institution and the results produced by them. A full assessment of management requires coverage of the following:

- The composition, structure, competence and involvement of the Board of Directors and the financial institution's management team;
- The adequacy of the management process in planning, organizing, directing and controlling;
- The effectiveness of the management style in nurturing and maintaining the financial institution's culture;
- The administration and supervision of the various operating and support activities, such as lending, investment, funding, fund transfers, human resources, accounting; and
- The adoption of modern management techniques to improve the effectiveness and efficiency of the financial institution.

The task of appraising a financial institution's management is highly subjective. However, to a significant extent, the quality of the administration and supervision of operations is reflected directly in

[2] See Basle Committee on Banking Supervision, Core Principles for Effective Banking Supervision, September 1997, especially principles 13, 14, and 15.

the financial institution's organization, policies, procedures and records. Furthermore, by observing financial institution practices and the condition of the financial institution's records, as well as talking to different levels of staff, bank supervisors will be able to gauge the awareness and understanding of policies and procedures used throughout the organization.

Some aspects of the management's functions related to planning, organizing, directing, and controlling are quantifiable, like the existence of an internal audit department, the availability of written policies and procedures, and the use of management reports. The adequacy of these functions can be assessed by bank supervisors from reviewing the financial institution's records, such as discussion papers, proposals, management reports, board minutes, etc.

The competence of management can also be gauged to a certain extent by evaluating the capital position, the quality of assets, the earnings trend, as well as the liquidity condition of the financial institution.

The difficult part of management appraisal lies mainly in the assessment of the performance of the Board of Directors, as well as the organizational, administrative, and human resource aspects.

III-B. THE BOARD OF DIRECTORS: ITS DUTIES AND RESPONSIBILITIES

The shareholders of the financial institution should have elected members of the Board of Directors who are accountable for the performance of the financial institution. These directors must be committed to discharging their statutory, contractual, fiduciary and moral duties. The financial institution must inform the BNA of any changes in directors. In its effort to protect the depositors' interests and to promote the soundness of the banking system, the BNA would expect that only persons of competence and integrity are permitted to serve on the Board.

The success and the growth of the financial institution is very dependent on the commitment and effectiveness of the Board of Directors. The Board must determine the financial institution's direction and perform the following five basic managerial functions:

- To establish the vision, the longer term objectives, and the business strategies to attain these goals;
- To define the specific policies (financial, personnel, credit, etc.) to be followed in implementing the financial institution's objectives;
- To determine the organizational structure of the financial institution at the management level and appoint individuals to fill key positions;
- To develop a management information system to ensure control over the results produced by the executive management; and
- To make major decisions on matters stipulated in the financial institution's articles of association (such as appointment of Board members), matters related to economic, political and technological developments; and operational matters that are too important to be delegated (such as considering large credit facilities or large capital projects).

The financial institution's Board should appoint qualified and competent senior executive officers to: (i) effectively supervise the affairs of the financial institution, (ii) formulate and implement sound policies in all major operational areas (e.g., loans, investments, asset/liability management, budgeting, capital planning, etc.), (iii) meet at least every two months (and a minimum of 12 times per year) to monitor the condition of the bank and compliance with policies, (iv) establish an audit and examination committee of non-executive directors, (v) set up an internal audit department, (vi) avoid self-serving practices and conflict of interest, (vii) ensure observance of banking laws and (viii) ensure that the financial institution has a positive influence on the community and the Angolan economy.

In discharging their duties, the directors must monitor the progress of the various operations of the financial institution. The following reports are considered necessary for the adequate supervision of the financial institution:

- Monthly comparative financial statements covering assets and liabilities, as well as income and expenses and showing performance pertaining to the previous month, the corresponding month of the previous year and the budget. There should be explanations for large changes;
- Investment reports showing the book value, market value, yield and a summary of purchases and sales;
- Loan reports by industry, economic sector, type of security and remaining maturity. The reports should highlight the large borrowers, undisbursed loan commitments, the amount of past due loans, the amount of nonperforming loans, the amount of restructured loans, specific provisions for loan losses and the progress of compliance with BNA's directive on loan classification and provisioning. Overall, the loan report should be sufficiently detailed to enable conclusions to be drawn about the profitability and general condition of the financial institution's loan portfolio;
- Monthly report of the financial institution's liquidity position; and
- Other regular and occasional reports, such as audit and inspection reports, annual review of the financial institution's insurance coverage, correspondence from the BNA or other authority to the board, annual projection of the bank's capital needs, and progress report on any financial institution litigation not relating to loans and advances.

In view of the many duties and responsibilities expected of them, the directors of the financial institution should not accept the appointment unless they can devote considerable time and energy to the affairs of the financial institution.

However, in order to ensure rapid response to business requirements, the directors should identify functions and issues that could be addressed by committees. The committees, made up of a smaller number of members than the full Board, should consist of directors who can be more active in making operational decisions on behalf of the Board. The committee should be delegated with certain authority beyond which the decision will be made by the full Board. In addition, the committees also preview matters that require in-depth consideration, and submit recommendations to the full Board of Directors for decision. Although the Board may rely on information submitted to it by the committees, it remains responsible for the decisions made.

All committees should be established with clear written statements of their objectives, authorities, responsibilities and duration. The best committee structure for a financial institution depends on its size and volume of business, the Board's composition and individual directors' expertise. Some typical committees of a financial institution include:

- **The Loan Committee:** As this committee has to meet quite regularly to consider and approve loan applications and discuss reviews of loan status, the directors involved are usually those who can devote more time to the financial institution's business. In most banks, senior management staff is usually enlisted as members of the loan committee.
- **The Investment Committee:** As investments constitute important assets on the balance sheets of banks/nonbanks, some large banks set up investment committees to ensure proper management of the investment portfolio. An investment committee formulates the financial institution's investment policy and evaluates the securities portfolio to ensure that the financial institution's investment policy is complied with.
- **The Audit Committee:** To ensure proper accountability, the Board should also form an Audit Committee to review the audit and inspection reports and present major findings to the full Board of

Directors for information and action. This Committee should consist of directors who are not members of other decision-making committees. Its function is to monitor financial institution compliance with Board policies and applicable laws and regulations.

III-C. STRATEGIC & OPERATIONAL PLANNING

The process of management involves a series of functions including strategic and operational planning. Planning refers to the function of making advance projections or preparations to achieve certain targets. Planning is fundamental to effective management as it provides the appropriate orientation and direction needed to achieve goals and objectives. The nature of planning may be strategic or operational. **Strategic planning** focuses on long-term deployment of resources to achieve corporate goals. **Operational planning** concentrates on short-term actions based on the strategic plan.

Planning is one of the major responsibilities of the Board of Directors. The Board must set the direction to be taken by the financial institution in light of the changing external economic environment and internal resource capacity. Therefore, it is the active Board that should formulate the financial institution's strategic plan instead of approving a summation of objectives set by the divisional management.

For financial institutions, the strategic and operational planning process includes the development of a mission statement. The mission statement expresses the philosophical objective of the financial institution. It defines the type of institution the financial institution wants to become and is the ultimate yardstick against which all decisions are made and results are measured. For example, if the mission statement of a bank states that its goal is to become the largest retail bank in the industry, one of its strategies may be to establish an extensive branch network throughout the country.

III-D. INTERNAL CONTROL

Internal control refers to the management and monitoring organizational performance so that plans are executed as intended and actions taken to correct any deviations. Internal controlling also provides timely feedback to management on whether the plan is appropriate and adequate.

Controlling also involves strategic and operational controls. Strategic controls are concerned with long term problems, such as slow service, lack of efficiency and loss of customers. Operational controls revolve around deviations in financial performance.

Effective controls necessitate the establishment of the following:

- **Control systems** to ensure that the actions are consistent with the plan and policies;
- **Measurement systems** to evaluate deviations or exceptions;
- **Management information systems** (data processing systems) to generate meaningful reports on progress being made in achieving strategic targets and deviations in that progress; and
- **Audit programs** provide an independent assessment of the extent to which the financial institution is in compliance with its own control systems.

Symptoms of inadequate controls or misguided control systems include:

- Unexpected decline in performance or increase in costs;
- Disorganized operations, such as bottlenecks and excessive paperwork;
- Increase in customers' complaints due to deterioration in service;
- Increase in employee grievances and turnover due to frustrations with systems; and

- Evidence of inefficiency, waste, and idle resources.

III-E. POLICIES AND PROCEDURES

Usually, policies and procedures are written by senior management based on existing practices found in the financial institution and the industry. Policies and procedures should be formally approved by the Board of Directors.

Policies are guidelines in the form of statements of direction issued by the management or the Board of Directors. They provide a framework for making decisions at the operating level. Policies should be stated in broad terms to cover varying situations and to allow discretion in execution. Because conditions change, policies should be reviewed periodically to determine whether revisions are needed.

Procedures are specific instructions for carrying out policies. They are established to standardize the operating processes and ensure consistency among financial institution employees performing specific tasks inherent to key banking functions, such as the extension of credit, the foreign exchange position (in the case of commercial banks), asset/liability management, internal audit, liquidity, capital, etc.

III-F. MANAGEMENT INFORMATION SYSTEM (MIS)

A comprehensive management information system (MIS) normally comprises a well-established computer system with well developed programs producing user-oriented reports. Such a system can provide important support enabling the financial institution's management to assess and monitor the financial institution’s operations and the risks inherent. The system should include data processing pertaining to the following areas: 1) accounting; 2) clearing; 3) credit; 4) invisibles; 5) personnel; and 6) management of inventories. Under ideal circumstances (where funding permits), the data processing system should be integrated, thereby permitting information to flow between departments, branches or between branches and the head office.

III-G. HUMAN RESOURCE MANAGEMENT

Financial institutions, like other businesses, are dependent upon the quality of their human resources for their ability to run a competitive, efficient operation. Financial institutions must ensure that competent employees with integrity and a professional attitude are employed and that each job is matched with appropriate personnel. An important role of management is to procure, develop and maintain the quality and quantity of the human resources necessary to achieving the financial institution’s objectives.

Human resource management involves recruitment, orientation, training and development, as well as termination. Banks/nonbanks must ensure the quality and consistency of these administrative functions by establishing human resource policies and standard human resource management procedures. Some features of good personnel management include:

- A well-defined organizational structure with detailed job descriptions;
- Carefully planned recruitment;
- Appropriate training and development;
- Regular performance review; and
- Salary administration.

An important consideration in human resource management is the provision of a clear definition of duties and responsibilities at all levels of the organization. Such a definition requires the drawing up of an

organization chart and the elaboration of **terms of reference** according to job category**.** Each job, and the responsibilities it entails, will then be clearly defined so as to avoid any ambiguity. By establishing lines of authority for each position, the financial institution determines the internal standards for performance review and evaluation. The use of a formal organizational structure and detailed job descriptions also facilitates recruitment and the communication of job expectations to potential employees.

Training and development is essential for the improvement in the quality of the financial institution's human resources. Financial institutions should provide training to improve the effectiveness and efficiency of its employees not only with respect to the job being performed but also to prepare the employees for merited job promotions. Commonly, banks/nonbanks spend a given percentage of the previous year's total gross salaries on training.

A **performance review** should be conducted yearly to complement training and development. To be effective, performance review should start from the top level, with the chief executive officer of the financial institution setting the example by reviewing the performance of other senior officers on a yearly basis. These officers in turn should review the performance of those working under their direction. Adequate recognition should be given to employees who performed well, while those wanting in performance, should be advised and appropriate actions should be taken to rectify the shortcomings.

Salary and benefits administration addresses the needs of human resources. Salaries paid (according to occupational group and level), as well as fringe benefits provided, generally determine the quality of the employees working for a financial institution. Compensation, however, encompasses more than salary. Good working conditions, job security, prestige and opportunity for advancement constitute additional components of overall remuneration. The adequacy of a financial institution's compensation package is generally indicated by the caliber of the financial institution's officers and employees and their morale.

Termination of service requires careful administration. It includes resignation, retirement and dismissal. The financial institution's human resource department should formally interview all resigning staff (exit interview) to determine the reasons for resignation, and report any weakness in human resource management to the Board for consideration.

Staff retirement should be monitored so that actions can be taken to ensure continuity and consistency in the quality of work. Most financial institutions provide some form of retirement benefits. Such benefits should be clearly expressed in the personnel policy and be made known to the staff. The retirement benefits, especially those for the senior officers, should be reasonable and be based on the number of years of service and the extent of contribution to the financial institution.

Staff dismissal is a matter for concern and requires careful consideration by the financial institutions, as legal and moral issues are involved. As far as possible, each financial institution should prepare a general list of unacceptable behavior and actions as well as appropriate responsive actions that can be taken by management.

IV-A. (1) RISKS

The risks faced by the financial institution with respect to management are the following:

- Failure of management to ensure the survival and growth of the financial institution in the long run;
- Failure of management to discharge its fiduciary duties towards shareholders and depositors;
- Failure of management to ensure full compliance with banking laws and regulations; and
- Abuse of power and authority.

The financial institution must have addressed the above risks by hiring a competent management team that demonstrates total commitment to the institution's soundness and profitability. The shareholders of the financial institutions should elect Board members who can contribute positively to their performance.

The success and growth of the financial institution are largely dependent on the commitment and effectiveness of the Board of Directors. The BNA expects the Board of each financial institution to be strong, professional, independent and actively involved in the affairs of the financial institution. The Board must determine the financial institution's direction, plan business strategies, and control the pace and progress of the financial institution in attaining its goals.

The Board should meet regularly with full attendance and maintain a record of the proceedings of the meetings, indicating actions to be taken, the basis of decisions made, and the individuals in attendance. The Board should discuss and formulate policies and standard procedures covering all major operational areas such as loans, investments, asset/liability management, profit planning and budgeting, capital planning and human resource administration. The Board should also set out clearly the authority for all areas of operation, and at all levels of management and staff.

With respect to results arising from the External Audit or the BNA's Inspection and Supervision process, the Board should discuss and review carefully any significant audit and examination comments (especially those relating to inadequacies of systems). Actions should be taken promptly to rectify any shortcomings noted.

The Board of Directors is ultimately responsible for the condition of the financial institution and should therefore direct the financial institution's internal auditors and management to assist it in identifying any problems which the financial institution may be experiencing.

The senior management, (the chief executive officer, the general managers, including branch managers, and the department heads) of the financial institution is responsible for the daily management of the financial institution, making operating decisions in accordance with the policies established by the Board. The chief executive officer should conduct weekly meetings with the other senior management officers to closely monitor financial institution operations. Major problems should be taken up with the Board of Directors or its committees.

To enhance professionalism in the banking industry, the BNA intends to issue regulations related to good corporate governance of financial institutions. These regulations are directed towards defining minimum standards of conduct expected of directors and staff, as well as towards strengthening the internal controls of institutions so as to allay fears of unethical practices. The three draft regulations that accompany this document are designed to meet these goals. They include:

(1) Code of Ethics pertaining to the conduct of administrators, directors, and employees of financial institutions;

(2) Duties and Responsibilities of administrators of financial institutions and appointment of chief executives;

(3) Prohibition of Loans to administrators, directors, employees and shareholders as well as their families and associated corporations.