ASIAN ROUNDTABLE ON CORPORATE GOVERNENCE

TASK FORCE ON

CORPORATE GOVERNANCE OF BANKS IN ASIA

DRAFT POLICY BRIEF

MEETING

BALI, INDONESIA, 8-9 SEPTEMBER 2005

INTRODUCTION

1. The Asian Roundtable on Corporate Governance ("Roundtable") serves as a regional forum for structured policy dialogue on corporate governance. In 2003, the Roundtable developed the *White Paper on Corporate Governance in Asia* ("White Paper") which provided region-specific guidance and suggestions to assist policy-makers, regulators, stock exchanges, and other standard-setting bodies in Asian economies.

2. At its 2004 meeting in Seoul, the Roundtable decided to establish task forces which would report back to the next Roundtable meeting with policy briefs focusing on specific corporate governance challenges shared in Asia and identified in the White Paper. The policy briefs will focus on policy issues and options to inform and support efforts by participants to improve corporate governance in their jurisdictions. The White Paper identified the corporate governance of banks as one of the six priorities for reform, and recommended that, "Governments should intensify their efforts to improve the regulation and corporate governance of banks" (White Paper #56). Underpinning this judgment is the fact that banks generally play a more important role in the Asian economies than in other economies with more developed capital markets.

3. This policy brief has been developed through active discussions within the Task Force on Corporate Governance of Banks in Asia ("Task Force"). The discussions have been inspired by thought-provoking presentations by knowledgeable speakers at a meeting in Tokyo in May 2005 hosted by the Asian Development Bank Institute. While all members of the Task Force occupy senior positions in their respective organisations, the findings and opinions expressed in this policy brief are personal and do not necessarily reflect the views of the organisations they serve nor the countries they come from.

4. This policy brief is a non-binding, consultative document and has been prepared on a consensus basis. It does not aim at detailed prescriptions for national legislation or regulation, but seeks to identify objectives and suggest various means of achieving them. It does not cover all issues in terms of the corporate governance of banks which are often similar to those of non-financial companies. Its purpose is to serve as a source of reference together with the *OECD Principles of Corporate Governance* ("OECD Principles") and the White Paper. These documents can be used by policy-makers/supervisors as they examine and develop the legal and regulatory frameworks for corporate governance of banks that reflect their own economic, social, legal and cultural circumstances, and by other parties including banking industry associations and banks as they develop their own practices.

5. The Task Force does not aim at developing any form of international standards, but is more concerned with effective implementation of existing norms. The Basel Committee on Banking

Supervision is currently[1] revising its guidance on *Enhancing Corporate Governance for Banking Organisations* ("Basel CG Guidance"). Other principles/guidance of the Basel Committee, such as the *Basel Core Principles for Effective Banking Supervision* and the *Internal Audit in Banks and the Supervisor's Relationship with Auditors* and a number of other risk management, sound practice papers, also stipulate standards for dealing with corporate governance issues related to banks. The policy brief has drawn on these principles/guidance, and the Task Force hopes that this policy brief can in turn add value to discussions within the Basel Committee on this topic.

6. The responsibility for developing good corporate governance of banks ultimately rests with the individual bank itself. Private bodies such as banking industry associations or institutes of directors often play important roles to assist the boards of directors and senior management of banks fulfil their responsibilities. Bank supervisors have the responsibility to provide a regulatory framework and guidance in terms of corporate governance of banks, and they should monitor individual banks and take necessary measures when a bank fails to achieve the minimum corporate governance standards necessary for banking. In addition, the corporate governance framework (not only of banks but any corporation) typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. Therefore, this policy brief is intended not only to assist policy-makers/supervisors in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance of banks in their countries, but also to provide guidance and suggestions for other parties such as stock exchanges, banking industry associations, and banks themselves. Some recommendations can be implemented by bank supervisors, banking industry associations or banks while others fall within the jurisdiction of capital market regulators or stock exchanges (e.g., through exchange listing requirements) since "banks" referred to in this policy brief can be either listed[2] or non-listed.

7. Some general aspects of the policy brief should be noted at the outset. First, although the Task Force has concentrated on industry-specific issues of corporate governance of banks, the policy brief inevitably covers several generic issues of corporate governance relating to institutional constraints and weakness in legal infrastructure. These respective issues are considered to be of particular importance in developing good corporate governance of banks in Asia. The policy brief is therefore broader in scope than the work of the Basel Committee. However, offering solutions to these problems is beyond the Task Force's mandate, although policy makers should nevertheless be aware that good corporate governance of banks cannot be developed effectively without tackling these weaknesses.

8. Second, although the policy brief is oriented towards identifying the issues affecting banking in general, it also addresses issues associated with some specific categories of banks. In particular, enhancing corporate governance of state owned commercial banks ("SOCBs") and family owned

---

[1] As of September 8th, 2005

[2] Use of the term "listed" throughout this paper refers to listing on a stock exchange.

banks ("FOBs"), which are still predominant in a number of Asian countries, faces several specific challenges[3]. In the case of FOBs, a key issue is how to ensure that related-party lending between the bank and its owner family, including group companies controlled by the same family, are conducted in a manner consistent with sound banking practices. In the case of SOCBs, an important issue is how to establish mechanisms which permit the government to act as an active, accountable owner, while at the same time avoiding day-to-day interference in the management of the bank.

9. In addition, in the Asian region there are also a number of listed banks with widely held shares. For these banks under dispersed ownership, the key challenge for improving corporate governance results from the separation of ownership and control. Challenges also remain in the effective enforcement of regulations and rules by securities authorities and stock exchanges, in addition to effective supervision by bank regulators. Banks with dispersed ownership (or banks with no "controlling owner") may be susceptible to intrusive government intervention in the selection of the CEO and board members as well as in major operational decisions.

10. Third, board structures and procedures vary widely among Asian economies. Some jurisdictions have two-tier boards that separate the supervisory function and the executive function into different bodies (e.g., in Indonesia, the Board of Commissioners serves supervisory functions and the Board of Directors serves executive functions), while others have unitary boards which bring together these functions. The policy brief does not advocate any particular board structure, and the term "board" as used in this document refers to the supervisory function and not to any particular national model.

---

[3] SOCBs and FOBs referred in this policy brief can be either listed or non-listed. The state/family may not always hold all (or a majority) of the bank's shares, but may instead hold only a significant and controlling portion of the voting rights.

PART I. THE IMPORTANCE OF CORPORATE GOVERNANCE OF BANKS AND THE CHARACTERISITCS OF ASIAN BANKS

11. The Task Force considers that the importance of corporate governance of banks differs from that of other companies because:
    (i) Shortcomings in the governance of banks, if widespread, can destabilise the financial system and pose systemic risks to the whole economy (White Paper #57). Banks determine which end-users receive financial resources and provide a means of payment. They also serve as a tool for the execution of monetary policy;
    (ii) Bank liabilities are largely in the form of deposits held by the general public, which means that other stakeholders (i.e., deposit holders), in addition to shareholders/owners, play a much more important role than in the non-financial sector. The boards and management of banks therefore usually have to pay relatively more attention to the interests of these non-shareholder stakeholders compared with non-financial firms;
    (iii) The risk of insolvency of banks might emerge abruptly because of the mismatch in maturity between liabilities (most deposits are available to depositors on demand) and assets (e.g., longer term loans). Banks typically have a very high debt-equity ratio, and the quality of banks' main assets (loan portfolio) is often rather opaque to outsiders compared with those of non-financial firms. Banks need to be perceived as both accountable to depositors and credible (i.e., they need to protect themselves against reputation risks) in order to manage the potential risk of a run on bank deposits;
    (iv) Banks and/or depositors frequently have access to government sponsored safety nets such as deposit insurance and the provision of liquidity by the central bank. These measures may reduce the need for the public (e.g., depositors) to monitor banks. They can change the behaviour of banks towards taking more risk (i.e., moral hazard), and, furthermore, banks can often escape consequences of improper action for a prolonged period thanks to the safety nets. Poor corporate governance of banks in such circumstances may increase the probability of bank failure leading to high costs for taxpayers; and
    (v) In addition to the usual institutional constraints which affect all firms, banks are also subject to numerous prudential regulations which research shows can have both positive and negative effects. Securing good (public) governance of supervisory institutions and efficient regulation is a prerequisite for good corporate governance of banks.

12. Discussions about corporate governance of banks in Asia also need to take a number of region-specific factors into account:
    (i) Corporate governance practices vary in Asia reflecting the wide variety of legal, economic and cultural traditions (White Paper #33-34);
    (ii) While most Asian economies have substantially revamped their corporate governance laws, regulations and norms in recent years, challenges lie in their implementation and enforcement. Reflecting the relatively short history of development in the region, many

Asian economies have not built up sufficiently the institutional infrastructure (e.g., sufficient resources, experience, focus and know-how) necessary for effective enforcement; and

(iii) Asian banks play a dominant role in regional finance. Securities markets in many Asian economies are not yet as mature as in many market-oriented countries. The failure of bank corporate governance in Asia has resulted in more serious economic consequences than in other regions (e.g., 1997 Asian crisis).

PART II. MAIN ISSUES / PRIORITIES FOR REFORM IN THE CORPORATE GOVERNANCE OF BANKS IN THE ASIAN CONTEXT[4]

2.1 The fiduciary duties of the board members in Asian banks

13. The fiduciary duty of all board members (i.e., not only of independent directors but all members of the board) comprises both the duty of care and the duty of loyalty. **The fiduciary duty of board members of banks should be more important than those of other companies irrespective of the legal traditions of the jurisdiction where the banks are operating.** In addition to the fiduciary duties that apply to board members in general, board members of banks need to be consciously aware, and regularly reminded by bank supervisors, of the banks' responsibilities as fiduciaries because banks accept and manage other people's money in the form of deposits. The fiduciary responsibilities of board members cannot be discharged effectively without sufficient skills and personal abilities, including maintaining "healthy scepticism" in their assessment of management and the bank's strategies, policies and processes. **Their skills should be enhanced by continuing training programs (provided by, for example, professional associations such as institutes of directors or stock exchanges) that underscore the professional, ethical and technical demands that this heightened fiduciary duty imposes upon a bank board member.**

14. Besides the aforementioned fiduciary duty, board members and executives of banks should have high ethical standards. **Considering the importance and characteristics of Asian banks mentioned in Part I, it is incumbent on board members to ensure high ethical standards throughout the bank so that the management will be more effective in balancing the often conflicting demands from employees, borrowers, and other stakeholders**.

2.2. The roles and functions of the board in Asian banks

15. The board is not only accountable to shareholders and depositors but also has a duty to act in their best interests. Together with guiding a bank's strategy and formulating its policy, the board is also responsible for monitoring managerial performance and achieving an adequate return for shareholders, while avoiding conflicts of interest (or managing conflicts of interest where they cannot be fully prevented), and balancing competing demands on the bank. This policy brief does not repeat every specific board function derived from the aforementioned duties/responsibilities as they are more fully developed in the OECD Principles. Among these functions, attention is rather given to issues that the Task Force considers to be of particular importance to the board of banks.

---

[4] The list of issues and challenges discussed in this policy brief reflects Task Force members' personal views and the order follows logical sense and thus does not imply anything about the relative importance of issues discussed.

16. The business of banks nowadays involves increasingly complicated transactions both internationally and domestically, and the corresponding regulations and rules are becoming more specific and technical. The boards of banks are, however, required to be more involved in the broad strategy rather than becoming immersed in operating details. **They should focus on (i) the formulation of strategy and policies, and (ii) the creation of structures/processes which include setting up of both clear responsibility/accountability lines throughout the bank and strict internal control systems ensuring effective oversight. More specifically:**

    (i) **An important aspect in the formulation of strategy and policies by the board is the development of a code of conduct (code of proper practice) for the bank, the management and the members of the board. It is recommended that bank supervisors (or banking industry associations while exchanging views with bank supervisors) develop, and regularly review and update a template available to banks for this purpose.** The template does, however, need to avoid the danger of box ticking behaviour by the board. The board is responsible for setting the "tone at the top" by example to nourish a bank culture with high ethical standards. **Board members should abstain from voting or even taking part in any decision-making processes on any matter which may involve them in possible conflicts of interest.** They should not interfere in those decisions and not even to create an impression of self-dealing. Bank boards should establish such a rule and ensure the compliance of the board members; and

    (ii) Concerning the creation of effective structures/processes, effective boards should clearly define the areas where they have authority and key responsibilities, as well as those of senior management. Although these are not exclusively true to banks but to any firms, both financial and non-financial, they are worth emphasising here as they are critical. For instance, **boards should evaluate the performance of, and have the power to appoint and remove key executives, including the CEO. They should also ensure that senior management follows with clear accountability a system of well-defined decision-making authority for the staff including workable internal control systems. They should make it clear that executives are ultimately responsible to the board for the performance of the bank. Furthermore, dedicated executives[5] should be designated as accountable to the board in terms of specific key functions.**

17. **If the board is to fulfil its functions properly, sufficient flows of information, internal and external, and managerial support to the board should be ensured.** It will enable effective and timely decision-making and overseeing by the board. Senior management should recognise the critical function of the board under a modern corporate governance regime and the necessity to provide sufficient information, analysis and support to the board. While board members, especially non-executive directors, should not be deeply involved in the day-to-day operations of the bank,

---

[5] They may include the Chief Credit Officer regarding the board's independent credit review, the Chief Financial Officer regarding the board's monitoring of budget and finance, and the Chief Compliance Officer regarding the board's overseeing of compliance matters. The Chief Internal Auditor should also be available and accountable to the board in terms of internal audit and controls.

they should nevertheless have access to the staff for any information they need to properly fulfil their duties, and should be formally entitled to obtain technical support from the staff. Furthermore, the board should have the financial resources to obtain additional advice/analysis from outside experts when appropriate. Last but not least, the board should have sufficient opportunities to obtain the views directly of internal and external auditors.

18. Individual board members and executives should pass a "fit and proper test" in terms of their expertise and integrity before their appointment and on a continuing basis thereafter. **The test should be designed in accordance with the Basel Committee's *Core Principles of Methodology* which sets a higher standard for bank board members than for those in other companies.** Moreover, the performance of the board as a whole and that of individual board members should be regularly evaluated by the board. For this purpose, **the board should set up its own internal committee, ideally made up of independent directors, for undertaking such a performance evaluation in a fair and constructive manner.**

19. Bank supervisors are expected to place more emphasis on securing good corporate governance of banks they supervise rather than to only focus on regulatory compliance. As the role of the board is crucial in developing good corporate governance of banks, **bank regulators should assess the performance of the entire board by, for instance, reviewing minutes of board meetings when necessary, and by checking the availability to board members of necessary information and resources, including staff support.** In addition, with due consideration to national conditions, they may also be legally entitled to audit board meetings of banks when they think it is appropriate. **They should issue warnings and, when necessary, ask the bank to reorganise its board framework and operational procedures.**

2.3. The composition of the board

20. **Asian banks should be encouraged to have more independent directors than other companies,** as abusive related-party transactions (including lending) might have more serious consequences in banking than in most other industries. The incentives to enter into related-party transactions, especially in the case of FOBs, are also probably much greater than in most other companies. There are many forms of related-party transactions, and not all of them are harmful (e.g., they can be made consistent with market terms) but they do involve conflicts of interest. Banks should be careful about making credit decisions concerning these transactions because it is not always easy to judge whether they are on market terms. Moreover, even if they are harmless the appearance of conflicts of interest can undermine the ethical code of the bank. The OECD Principles stipulate that the review of related-party transactions should be undertaken by a sufficient number of "independent" directors capable of exercising independent judgment to ensure that such transactions are conducted at arm's length and in the interest of the bank (OECD Principles, page 65).

21. In the case of FOBs in Asia, controlling shareholders often appoint the entire board, and the real objectivity and independence, and therefore the real added value, of nominally "independent" directors can be undermined. **"Independent" directors of FOBs should be independent not only of management but also of controlling shareholders.** For example, one code suggests that relationships and circumstances which could lead to board members not being "independent" would be if they have, or have had within the last three years, a material business relationship with the company (bank) either directly, or as a partner, shareholder or director or senior employee of a body that has had such a relationship with the company (bank). The issue is also relevant to SOCBs. The boards of SOCBs should include a sufficient number of "independent" directors so that the board is able to make decisions independent of the state's possible day-to-day intervention, while effectively monitoring the management in accordance with the objectives set by the state in its capacity as owner or controlling shareholder. The Task Force strongly advocates the White Paper's recommendation that "Asian countries should continue to refine the norms and practices of "independent" directors" (White Paper #318).

22. Although mandatory separation between the CEO and the Chairman is not widespread in Asia, the Task Force believes the decision to separate the two posts, with due consideration to the business environment in the country, can help achieve an appropriate balance of power, increase accountability and improve the board's capability for decision-making independent of management. In that case, the chairman should ideally not only be a non-executive but also an independent director so that the board which he/she chairs can make impartial, independent decisions. **However, in countries where it is still difficult to attract a sufficient number of independent directors in general, the appointment of a non-executive chairman, for the time being, can contribute to achieving a better balance of power in the board and improve the operation of checks and balances.** In the case of two-tier board systems, the chair of the two boards should be separated. Also, the tradition in which the head of the managing board becomes the chairman of the supervisory board on retirement should be set aside[6].

2.4. The committees of the board

23. The Basel CG Guidance notes that certain specialised committees - an audit committee, a risk management committee, a compensation committee and a nominations committee - have been found to be beneficial in many countries. Board committees for banks are increasingly mandated by law in Asian countries.

24. **The audit committee should ensure that the bank adheres to the mandated international accounting and audit standards and practices as well as the guidance established by the Basel**

[6] The Task Force recommends this because any changes proposed by a new head of the managing board need to be assessed by his/her predecessor, who may not be inclined to be objective or accept changes from how he/she managed the bank.

Committee, *Enhancing Transparency in Banking*. The audit committee should be charged with the duty of recommending the selection and hiring of external auditors properly certified to carry out the specialized external audits of a bank. Moreover, the bank's internal auditors should be reporting on a mandatory basis directly to the audit committee on matters concerned with the effective implementation of strategy, policies and controls which are in the competence of the board. The audit committee is ideally made up of independent directors[7] with the appropriate banking or financial expertise.

25. **A risk management committee should be established, with the primary duty of overseeing that the bank's risk management system is implementing the risk policy of the bank.** It is also the appropriate body to consider the requirements of the new Basel Framework. Relevant risks include credit risk, market risk (e.g., risk in bank's trading activities), liquidity risk, operational risk (including legal risk) and interest rate risk in the banking book. Its role should include reviewing the risk management policy of the board and also requesting and obtaining from senior management periodic information on both risk exposures and risk management activities. It should ensure that adequate systems of risk management are developed and that controls are enforced properly.

26. **In order to avoid the proliferation of too many board committees, it may be an effective alternative to set up a single committee that combines the responsibilities for nomination, remuneration, succession planning and other board members' concerns including their continuing training and access to technical support and information**. Such a committee – which could be called a "governance committee" – should also evaluate regularly the performance of board members and the board as a whole in a fair and constructive manner based on clearly-written factors for the performance evaluation. It is essential that the governance committee, ideally made up of independent directors, operates to secure the independence and enhance the capacity for independent judgment of board members and the board as a whole. In this regard, the nomination of independent directors, which are often made by the controlling shareholders, should be transferred to the nomination/governance committee.

27. **Finally, it is also worth considering the establishment of a specialised committee for monitoring and approving related-party transactions which are serious problems in Asia** as discussed in further details in paragraph 31 below.

2.5. Appropriate credit allocation preventing abusive related-party transactions

28. In Asia, experience has shown that special focus should be given to the credit allocation process that banks observe. The specific corporate governance challenge in this regard continues to be that of ensuring that this process is conducted with the view of securing the long-term viability and sustainability of the bank, thereby maximising its long-term value. The committee structure within

7 As discussed in paragraph 21, non-executive directors are not always independent directors.

the board should preclude decision-making becoming the prerogative solely of any single individual or of the controlling owners, without a system of independent checks and balances. An appropriate credit allocation process can be secured by mechanisms as discussed hereinafter (i.e., firewalls) to prevent self-dealing and the favourable treatment of related parties.

29. Existing regulation on a bank's lending exposure to a single client, including exposures to related entities owned or controlled by a single client (single borrower's limit), should remain, and where necessary, should be tightened. A mandatory maximum percentage of a bank's capital, which generally accepted international practice prescribes a ceiling of 25%, should be set as a limit by bank supervisors. Besides such a ceiling, **it might be also advisable to legally restrict the amount of lending to controlling shareholders to within the amount of these shareholders' capital contribution to the bank.**

30. In recognition of the damage that was inflicted upon entire economies from abuses of related-party lending, some jurisdictions have started to move further, even to the extent of limiting ownership (up to 10%) and voting rights (up to 4% for certain types of votes[8]) of individual owners or of a single family in a bank. Other jurisdictions are moving towards setting up strong firewalls between the controlling ownership of financial and non-financial companies. For example, owners with a controlling interest in a bank or financial institution are prohibited from having a controlling interest in non-financial institutions in several jurisdictions. **Other economies in Asia are encouraged to consider broadly similar policies - appropriate to their circumstances - which establish an arm's length relationship and proper professional distance between the credit decisions of banks and the borrowers to which they are related.**

31. Related-party transactions should be reviewed and monitored by a sufficient number of independent board members capable of exercising independent judgment. **It might also be appropriate to establish a committee whose membership is made up exclusively of such independent directors for monitoring and approving related-party transactions.** In that case, the committee's decision should be final and legally binding on all related parties involved and on the banks' board. The Task Force agrees with the White Paper recommendation for utilising board committees as a common mechanism for controlling matters involving potential conflicts of interest (White Paper #322).

32. The Basel Committee's *Core Principles for Effective Banking Supervision* also recommends that banks be required to report bank supervisors those transactions with related parties that pose special risks to the bank. **Therefore, bank supervisors should implement a regulation in which minimum criteria of such "transactions with related parties that pose special risks" are clearly defined. Bank supervisors should also require the bank board to monitor and**

---

8 In view of the fact that control of banks is often associated with voting rights considerably in excess of cash flow rights, mandatory voting caps in banks for electing independent directors who will serve on certain committees is recommended.

report to them those transactions which fall short of the abovementioned criteria but may nevertheless pose significant risks for the bank.

33. **In accordance with international standards for accounting, audit and non-financial disclosure, it should also be mandatory for related-party transactions to be disclosed by listed banks. Non-listed banks should also be required to report the nature and extent of these transactions to the bank supervisor. In addition, if legally possible under the national legislation, disclosure by non-listed banks to other stakeholders (e.g., depositors) would facilitate more effective monitoring of the corporate governance practice of the non-listed banks.** It is important for the market and stakeholders, in addition to the bank supervisors, to know whether the bank is being run with due regard to the interests of all its stakeholders, and it is essential for the bank to fully disclose material related-party transactions either individually or on an aggregate basis. It will also help bank supervision and reduce the logistical burden for bank supervisors which may have limited human resources.

34. Finally, the White Paper recommendation implies that there is also an option of prohibiting listed companies from engaging in *certain specific types of* related-party transactions including personal loans to controlling shareholders and board members (White Paper #117). This option should be closely considered by both banks and supervisory authorities.

2.6. Bank holding companies and groups of companies containing banks

35. Banks can be, depending on the legal framework of the country in which they operate, either subsidiaries or parent companies. Although there are varieties of conglomerates[9] to which banks belong (hereinafter "bank group"), all of them need special consideration in their corporate governance. **The corporate governance structure/practices of both the bank itself and the bank group is a legitimate concern of public policy since banks are entrusted with deposits under the public safety net.** Major challenges for bank groups lie in preventing abusive related-party transactions to the detriment of depositors of a bank within such groups, and avoiding ambiguity in terms of the division of labour and corresponding responsibilities between the bank and its affiliated parent company/subsidiary.

36. **The legal form and the position of the banks within a bank group should not lessen the responsibility of the bank's board members and management for operating under good corporate governance practices, nor should it be used to lessen accountability as a**

[9] A parent company which has a banking subsidiary could be a "pure" bank holding company which owns 100% of the bank's shares and does not engage in other businesses. It could be a financial holding company which holds the shares of banks and other financial institutions. It could also be a company engaging in its own commercial operations while holding the controlling shares of the bank. On the other hand, subsidiaries of banks could include other banks, financial institutions and/or other commercial companies if the law so permits.

supervised entity[10]. The corporate governance structure/practices of the bank within a bank group should be in accordance with the recommendations stipulated in other parts of this policy brief (i.e., banks should be subject to strict corporate governance standards irrespective of whether or not they belong to a bank group). For instance, the board members of the bank, even if they are appointed by the parent company, should be aware that they have duties to depositors in addition to the fiduciary duties to all shareholders. The bank's board should include a sufficient number of independent directors[11] who are also independent from the parent company. Necessary committees whose members include independent directors (exclusively, if possible) should be set up even if the bank is wholly owned by a parent company since, in many cases, there is a need for objective judgment by independent directors who may more readily represent the interests of depositors than non-independent directors. Moreover, the bank should adopt firewalls mentioned in section 2.5. in order to prevent abusive transactions to the detriment of the bank's safety and soundness.

37. A bank's parent company should not impede the full exercise of the corporate governance of the bank within a bank group, although some activities such as internal audit and risk management might be provided by the bank group as a whole. The parent company should refrain from intervening in day-to-day operations of the bank, especially with regard to the specific decisions on lending and investments. As mentioned above, the parent company as a single/controlling owner should appoint a sufficient number of independent directors to the board of the bank, and allow the board to fulfil its duties. **The board of the parent company, on the other hand, should also have a sufficient number of independent directors and the necessary board committees discussed in section 2.4. The "fit and proper test" should also be applicable to the board members and executives of the parent company.**

38. **Bank supervisors should have the legal authority and tools to effectively supervise the bank group including the parent company.** The extent to which they should supervise the bank group may depend on the level of control by the parent company. In the case of a "pure" holding company, for instance, the supervisors should have virtually the same legal authority over the holding company as the authority over the bank such as authorising/revoking the license and issuing cease-and-desist orders when appropriate. They must have the means and legal powers to gather information, both on and off-site, not only from banks but also from their parent companies.

---

10 The board of the bank within a bank group is, in fact, expected to take a wider range of facts into consideration than those of other banks. It should pay, to a certain degree, attention to the operations of other companies within the bank group because problems/scandals in such companies may result in reputation risks to the bank. Above all, the bank group should be a source of strength and not weakness for the bank.

11 The Task Force believes that an independent director of a controlling company who also serves on the board of a bank is not considered to be an "independent" director, with rare exception where the parent company is a "pure" holding company which holds the entire equity of the bank and does not engage in other businesses than holding the equity of that bank.

The legal framework in a jurisdiction should not allow the group structure to obscure where responsibilities lie between a bank and its parent company. **The legal obligation of the board of the bank and its parent company should correspond to where decisions are made in the bank group.** Thus, the board members of the banking subsidiary should be legally liable for a possible derivative lawsuit filed by the shareholders of its parent company regarding decisions they have taken.

2.7. Disclosure

39. The White Paper also recommends that Asian countries should work towards full convergence with international standards and practices for accounting, audit and non-financial disclosure (White Paper #202). Securities laws in Asian countries mandate listed companies, including listed banks, to disclose certain specified information to the public. As such disclosures are crucial for ensuing good corporate governance of banks and promoting financial stability in a country, listed banks should be in compliance with international accounting standards and practices as well as the guidance advocated by the Basel Committee such as *Enhancing Transparency in Banking*. Banking laws in Asian countries often mandate disclosure requirements even for non-listed banks by making their annual report available for public inspection, which is crucial because the general public entrusts their savings to banks. **In that case, non-listed banks, in so far as they are required to disclose their information to the public, should also adhere to these standards and practices. In the case of SOCBs, they should, whether listed or not, be subject to an annual independent external audit based on international standards** (in addition to the specific state audit which is mainly designed to monitor public funds and the use of budget resources). The state should maintain a continuing dialogue with the external auditors so long as this is compatible with company law.

40. Concerning compliance with disclosure requirements by listed banks, the Task Force would like to stress the importance of co-operation between bank supervisors, securities regulators and stock exchanges. Even if the primary authority for ensuring proper disclosure of banks rests with banking supervisors, securities regulators are not exempt from their responsibilities; as noted in the White Paper, securities regulators are required to exercise oversight and enforcement of standards for accounting, audit, and non-financial disclosure (White Paper #238). **Problems identified by bank supervisors regarding disclosure by listed banks should be shared in due course with securities regulators and stock exchanges for possible sanctions/penalties according to securities laws/regulations, and vice versa.**

2.8. Banks' autonomy in relation to the state

41. Reflecting the crucial position of banks in the economy, the state usually has a keen interest in banks' operation. Besides financial safety nets, the state's interest can be manifested through prudential regulation and/or the state ownership of bank shares. The role of the state as a

regulator/supervisor and an owner should be considered separately; however, in either case, the state should be aware of the potential risks that its intervention may result in serious, and potentially harmful, consequences.

42. In terms of prudential regulation, there has been a steady, and justifiable, trend in which bank supervisors have been required to enforce strict and effective supervision. However, it should be stressed that excessive regulation and exercise of supervisory authority, often driven by political consideration, can be counter-productive. Moreover, virtually any prudential regulation may, more or less, potentially distort the incentive structure for management (e.g., regulations relating to bank ownership, which are necessary and recommended, may nevertheless lead to potential moral hazard through management's entrenchment if the market in corporate control is restricted.). Policy-makers should take into account national conditions and carefully consider both benefits and costs, including possible distortions, when they are considering new regulation.

43. In the case of state ownership of banks, SOCBs' policy goals set by the state cannot be achieved efficiently by the intervention of government in the day-to-day management of SOCBs. It could even be harmful if such intervention is not disclosed and, consequently, neither the state officials nor the management /board of SOCBs are accountable for the results of the intervention. For instance, state officials should not interfere in any specific lending decision of SOCBs even if the SOCBs are specifically dedicated to implementing certain state-designed lending policies (e.g., agricultural finance). **Instead, the state should properly utilise and respect the legal corporate structure of SOCBs which is most often that of a joint stock company. That is, once the state as sole shareholder has set the objectives for the SOCBs, it should let SOCB boards exercise their responsibilities and respect their independence**. The authorities thus should take advantage of the corporate form which presumably is one reason for separating the banks from the administration in the first place. The recently adopted *OECD Guidelines on Corporate Governance of State Owned Enterprises* represent good practices which should also be applied to SOCBs.

44. The Task Force welcomes the general trend towards privatisation of SOCBs in Asia, especially for those banks which were originally taken into state ownership as part of the resolution of a banking crisis. The privatisation of state owned banks in general, with limited exceptions such as policy lending banks (e.g., development banks), can bring market discipline and thus improve corporate governance. **It is imperative for the success of the privatisation of a SOCB that the best corporate governance practices available in a country are already adopted and implemented prior to privatisation.** By doing so, the re-privatised bank will function as a role model of good corporate governance and thus may create market pressure on other banks to adopt better corporate governance. It will also place new shareholders in a difficult position if they wish to reverse such reforms.

2.9. Banks' monitoring of the corporate governance structure of its corporate borrowers

45. Regardless of the efforts to develop securities and capital markets, banks in many Asian countries still play a more or less dominant financial role and often possess influential powers over borrowing companies. This explains why, in the course of discussions at the Roundtable meeting that established the Task Force, participants pointed out the necessity of a supplemental discussion on the role of banks concerning the corporate governance of their corporate borrowers. The discussion about this topic appears to have two aspects: (i) whether banks should actively assess and monitor the corporate governance structure of their borrowing companies, and (ii) to what extent the banks should seek to improve the corporate governance of borrowing companies.

46. The Task Force suggests that banks in Asia should recognise, and consider, that it is in the best interests of the banks themselves to assess and monitor, ex-ante and ex-post, the corporate governance structure of its corporate borrowers. Since poorer corporate governance practices have a direct impact on the creditworthiness of borrowers, both (i) the assessment of the corporate governance structure of companies to which banks are considering to provide loans, and (ii) the monitoring of these structures until the loans are repaid, form an important part of proper risk management. Research shows that this practice of banks has been largely neglected in many Asian banks. **Bank supervisors in Asia should encourage banks to assess and monitor the quality of the corporate governance structure of their debtor companies as a critical part of their credit risk management.** Considering that securing good corporate governance through securities market pressure, which in many cases is some way off due to the lack of well-functioning securities markets, the assessment and monitoring function of banks as a part of risk management may deserve more attention, both from the bank and the bank supervisor, as one of the effective policy tools for improving corporate governance practices in a country.

47. The aforementioned monitoring function by banks may place a burden on banks to a certain degree, but it may be supplemented by or substituted with covenants between banks and their corporate borrowers. Such a covenant should stipulate conditions regarding the corporate governance structure of the borrowers, and a deviation from this may lead to the bank's withdrawal of credit. It is desirable that these conditions are drafted in a way that a violation thereof can be easily judged (e.g., maintaining a minimum ratio of non-executive directors or separation of a chairman and a CEO) in order to prevent excessive intervention by banks and avoid unnecessary dispute. The covenant should involve the obligation of corporate borrowers to report to the bank when a deviation from it occurs[12], which would reduce the burden of monitoring by the bank.

48. The extent to which banks should try to influence the practices of their corporate borrowers needs careful consideration:
    (i) For instance, banks often allow their employees to act as a member of the board or senior manager of debtor companies even if they do not hold any shares. While bankers with

[12] Failure to report such a deviation will directly breach the contract, and thus would provide banks more incentives to take stronger measures when they find out uninformed deviation.

deep knowledge of corporate finance may be able to contribute to these companies, **such activities should nevertheless be discouraged, with some exceptions such as temporarily serving as a turn-around manager, because of the possible conflicts of interest. Such a director should not be regarded as an "independent director"; and**

(ii) One cannot expect banks with poor corporate governance to monitor and seek better corporate governance of their corporate borrowers. Banks whose minority shareholders are exploited by a controlling shareholder, for instance, might permit the borrowing companies to do the same or even allow those companies controlled by the same controlling shareholder to exploit the banks themselves. **Ensuring good corporate governance of banks themselves is the prerequisite if the banks are to play a role in improving the corporate governance of their corporate borrowers.**

2.10. Next steps

49. The Task Force includes both bank supervisors and securities authorities who have each been separately discussing the corporate governance challenges of banks. It is indeed an inter-disciplinary issue across the area of bank supervision and securities regulation as far as listed banks are involved. Acknowledging the unique features of corporate governance of banks and the necessity of harmonisation with existing rules applicable to non-financial listed companies, **the Task Force recommends that bank supervisors (or banking industry associations while exchanging views with bank supervisors), in conjunction with securities regulators and stock exchanges, should develop (making use of public consultation with market participants) and publicise a code of corporate governance of banks, a template on which banks should base the development of their own codes respectively, based on the conditions of each country and on existing corporate governance codes.**

50. **Furthermore, bank supervisors should, taking into consideration the code mentioned above, develop rating mechanisms for the corporate governance of banks which will provide incentives for banks to improve their corporate governance.** Non-financial companies are usually not subject to such an official rating; however, corporate governance of Asian banks requires special attention as mentioned in Part I. An example of such incentive is the possible differentiated deposit insurance premium reflecting the ratings on corporate governance instead of existing flat-rate system. If the costs of deposit insurances/guarantees which banks have to share are to reflect their ratings regarding corporate governance, it will provide incentives for the banks to improve their corporate governance. The methodology[13] of the ratings of corporate governance of banks should be articulated as clearly as possible and should be announced well in advance in order to provide banks time to reorganise their framework. It will also be necessary to emphasise principles and to avoid box-ticking actions by banks. Securities regulators should contribute to

[13] The criteria on corporate governance of banks stipulated in the ARROW (Advanced Risk Responsive Operating Framework) developed by the UK FSA might be one of the reference points.

developing the criteria by providing accumulated knowledge/experiences about corporate governance.

Members of the Task Force

Dr. Jesus Estanislao (Institute of Directors, Philippines) [Chair]

Mr. Anis Baridwan (Capital Market Supervisory Agency, Indonesia)

Ms. Ann Marie Kohlligian (Federal Reserve Bank of San Francisco)

Ms. Chitra Ramkrishna (National Stock Exchange of India)

Mr. Hong-Soo JIN (Financial Supervisory Service, Korea)

Mr. Ludger Hanenberg (Federal Financial Supervisory Authority, Germany)

Mr. Maulana Ibrahim (Bank Indonesia)

Dr. Sang-Woo Nam (Asian Development Bank Institute)

Mr. Toshihide Endo (Financial Services Agency, Japan)

Secretariats

Mr. Louis Bouchez (Organisation for Economic Co-operation and Development)

Mr. Motoyuki Yufu (Organisation for Economic Co-operation and Development)