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## APPENDIX

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CORPORATE GOVERNANCE IN THE FINANCIAL SECTOR

A report for central banks and banking supervision authorities in Commonwealth countries.

Issued by the Commonwealth Working Group on Corporate Governance in the Financial Sector

November 2000

Executive Summary

This report discusses the role that corporate governance can play in promoting robust and efficient financial systems. It has been issued by the Commonwealth Working Group on Corporate Governance in the Financial Sector, as part of the Commonwealth’s corporate governance programme. Its purpose is to assist central banks and financial sector regulatory agencies in Commonwealth countries to develop and implement policies to promote effective corporate governance in their financial sectors, for the ultimate objective of promoting sound and efficient financial systems.

The report assesses the key elements of corporate governance and discusses the policies and structures that can be adopted to promote effective corporate governance in the financial system.

The policies and structures for promoting robust corporate governance include:

- well designed and enforced company law, which specifies, among other matters, the duties and obligations of directors, the rights of shareholders and other stakeholders, disclosure and external audit requirements, mechanisms for the enforcement of the law, and penalties for non-compliance with the law;
- codes of principles developed by professional or industry associations, setting out desired attributes of corporate governance, and associated educational and consciousness-raising initiatives;
- high quality disclosure requirements for banks and other companies, based on robust accounting and auditing standards;
- measures to strengthen market disciplines in the banking sector, including privatising government-owned banks (or at least subjecting them to effective corporate governance arrangements), removing government guarantees of banks’ liabilities, ensuring that deposit insurance and bank failure response arrangements do not significantly weaken market disciplines, and promoting a contestable and competitive financial sector;
- effective banking supervision arrangements, with particular emphasis on supervisory policies that encourage sound governance and risk management practices;
- leadership by example, including the adoption of robust governance, accountability and transparency practices by central government, government agencies and regulatory bodies (including central banks).
**Introduction**

Recent episodes of financial instability have highlighted the potential fragility of financial systems and the effect that financial instability can have on the wider economy. In recognition of this, much international attention is now being given to understanding the causes and dynamics of financial crises and to developing policy frameworks for promoting robust and efficient financial systems. An important part of this work relates to corporate governance arrangements and the role that these can play in encouraging sound risk management practices.

Various international agencies, particularly the OECD, Basel Committee on Banking Supervision and World Bank, have been undertaking work in areas relating to corporate governance. The Commonwealth has also been actively engaged in promoting sound corporate governance arrangements within the Commonwealth countries. Through the Commonwealth Association for Corporate Governance, the Commonwealth has released extensive material on corporate governance practices, including a set of guiding principles.

In recognition of the importance of financial systems to the wider economy, and the role that corporate governance can play in promoting financial stability, the Commonwealth has initiated a work programme on corporate governance in the banking system. A working group comprising experts on corporate governance, central bankers and members of the Commonwealth Secretariat has been formed for that purpose. Part of this programme is the generation of this paper, which sets out background issues on corporate governance and identifies ways in which corporate governance in the banking sector can be strengthened.

This paper:

- Summarises the factors that can cause or contribute to financial instability, including weaknesses in corporate governance arrangements.
- Sets out the key ingredients required for effective corporate governance in the banking sector.
- Outlines ways in which effective corporate governance structures and best practices can be promoted in the Commonwealth region.

**Financial Instability and Inadequacies in Corporate Governance**

The world has seen many episodes of financial instability in recent years. In some cases, such as in parts of Asia in 1997/98, this instability caused significant dislocation to the wider economy, with severe consequences for economic growth and welfare.

*The factors that contribute to financial instability.* Financial instability is caused by many factors. These vary depending on the nature of a country’s economy and the structure of its financial system. However, some common causal factors can be identified, including:

- rapid financial sector liberalisation unsupported by measures to encourage prudent risk management in the financial sector (including a failure to build risk management capacity within financial institutions and effective structures to encourage sound risk management practices);
- inappropriate and unsustainable macroeconomic policies, such as loose monetary policy and excessive fiscal spending – such policies can contribute to asset price volatility and a subsequent erosion of asset quality in the financial system;

- exchange rate arrangements that lack credibility, including unsustainable exchange rate pegs - this is particularly important where financial institutions and corporations have come to rely on an exchange rate peg, and fail to hedge their currency risk, only to sustain currency losses when the peg collapses;

- poor transparency and accountability arrangements for economic and financial policies;

- excessive degrees of connected lending (lending to parent companies and associated parties) and lending under the direction of government;

- industry protection and policies that impede the efficient allocation of resources in the economy;

- poorly designed and implemented banking supervision and prudential regulation, including insufficient structures to ensure that banks maintain a prudent level of capital relative to their risks and have robust risk management systems, insufficient scrutiny of lending quality and exposure concentration, and inadequate measures to constrain connected or directed lending;

- weak enforcement of prudential regulations by the supervisory agency;

- inadequate financial disclosure arrangements, including poor quality accounting and auditing standards; and

- weak market disciplines in the banking and corporate sectors, which tend to reduce the incentives for high quality risk management by banks and corporates.

**Weak corporate governance has contributed to financial instability.** Another important factor that has contributed to financial instability in many countries is inadequate corporate governance in the corporate and financial sectors. Weak corporate governance (and associated risk management practices) in the corporate sector increases the risk profile of companies and exposes banks and other lending institutions to a greater risk of loss than would otherwise be the case. In a more direct sense, weaknesses in corporate governance arrangements in banks and other financial institutions reduce their capacity to identify, monitor and manage their business risks, and can result in poor quality lending and excessive risk-taking by financial institutions. For example, inadequate corporate governance arrangements can lead to poor management of credit risks, an insufficiently developed “credit culture”, excessive exposure concentration, poor management of interest rate risk and exchange rate risk, and inadequacies in the management of connected exposures. In some cases, inadequacies in corporate governance and risk management have the potential to lead to bank insolvency and financial instability.

Particular weaknesses in corporate governance arrangements in a banking system context can include:

- inadequately qualified and experienced bank directors, and directors with significant conflicts of interest;
Weak corporate governance is caused by many factors. Some of the underlying factors can include:

- insufficiently developed corporate governance law, including inadequate specification of directors’ duties, of the rights of shareholders and other stakeholders, of disclosure requirements and of the requirements in relation to conflicts of interest;
- inadequate enforcement of corporate governance law – possibly as a result of a poorly resourced judiciary and government authorities;
- inadequate development and enunciation of corporate governance principles by the relevant professional associations (such as a professional institute of directors or a banking industry association);
- insufficient competitiveness in financial and product markets, thereby reducing market disciplines on companies (including banks) and weakening the incentives for sound corporate governance practices;
- regulatory frameworks or government support arrangements that have the effect of weakening the incentives for sound corporate governance, for example, by weakening market disciplines on banks, by insulating creditors from losses in the event of a bank failure and by adopting supervisory arrangements that effectively result in risk management responsibility passing from bank board rooms to the supervisory agencies;
- poorly developed financial disclosure arrangements;
- poorly developed capital markets – inadequately developed equity and bond markets reduce the scope for the market to exert pricing disciplines on banks and other companies, and therefore dilute the incentives for the adoption of sound governance practices;
- corrupt practices within the government and business sectors; and
- inadequate attention to corporate governance issues and weak enforcement of prudential regulations by banking supervisory authorities.
Given the effect that weak corporate governance and risk management structures can have on the management of risks in the financial and corporate sectors, it is important that steps are taken to promote effective corporate governance in these sectors.

**Promoting Sound Corporate Governance**

Promoting effective corporate governance in the financial sector requires a number of measures to be taken. These include:

- the development of an effective legal framework that specifies the rights and obligations of a company, its directors, shareholders and other stakeholders, specifies disclosure requirements, and provides for effective enforcement of the law;
- the development of a corporate governance culture, including through the development of corporate governance principles by professional or industry associations;
- the creation of an environment conducive to encouraging effective corporate governance, including:
  - promoting high quality financial disclosure requirements;
  - promoting bank ownership structures that encourage sound governance;
  - strengthening market disciplines on banks, including by eliminating or minimising government support arrangements for individual banks and strengthening the incentives for market participants to monitor banks and other financial institutions;
  - encouraging well developed equity and debt markets; and
  - encouraging an effective financial news media;
- appropriate supervisory arrangements, focusing on (among other matters) encouraging the adoption of sound corporate governance practices;
- training and educational initiatives to build capacity in corporate governance at various levels, including directors and senior management of banks and financial regulators; and
- leadership by example, including by central government and regulatory agencies in terms of their own internal governance and transparency practices.

These points are elaborated on below.

**Effective Legal Framework**

One of the important underpinnings of corporate governance in the financial and corporate sectors is an effective set of corporate laws, setting out the basic legal rights and obligations of corporate entities and those of their directors, officers and stakeholders. The legal framework needs to be clear and accessible, and needs to strike an appropriate balance among the interests of the various parties involved. In that regard, there is a need to ensure that, in pursuing sound
corporate governance, the legal framework is not excessively inflexible and does not impose substantial compliance and efficiency costs on the banking and corporate sectors. It is also important that the legal framework does not induce an excessive degree of risk aversion in the banking industry (thereby compromising the banking system’s ability to meet the needs of the wider economy).

The legal framework will vary from country to country depending on various factors, including institutional arrangements and cultural factors, but in general, it could be expected to address such matters as:

- The powers and duties of directors, including: the obligations of directors in relation to overseeing the management of risks of the company and its overall business strategy; obligations to ensure that the company’s risks are competently managed; and obligations that the company does not incur debts if there is a significant risk of it being unable to repay the debt when it falls due.

- The need for directors to satisfy themselves that the bank or company is solvent (and likely to remain so) before making distributions to shareholders or otherwise taking on obligations, and to attest to this in writing.

- The rights and powers of shareholders and other stakeholders, such as creditors, including rights in relation to voting and access to information on the company.

- Requirements for identifying and dealing with directors’ conflicts of interest.

- The disclosure obligations of the company (including as to the preparation of financial statements, maintenance of accounting systems and audit arrangements). Company law could be expected to specify an obligation for directors to issue financial statements in relation to their company and the group of which it is part. In some countries, this obligation will mesh with a requirement for the financial statements to comply with particular disclosure standards, possibly including mandatory accounting standards, so as to encourage financial statements of high quality and comparability. Directors should be held liable for ensuring that the bank’s/company’s financial statements and other disclosures are not false or misleading.

Corporate law also provides an important mechanism by which enforcement of corporate governance can be achieved. One of the functions of corporate law is to set out the penalties for non-compliance with corporate governance arrangements. For enforcement to be effective, however, there is a need for more than just a clear, well-developed set of corporate law. There is also a need for a well-resourced government authority with the power and capacity to enforce breaches of corporate law and a legal system and judiciary capable of facilitating effective enforcement, including through civil claims. The government agencies responsible for enforcement, and the judiciary, need to be accountable for the exercise (or non-exercise) of their powers. Accordingly, structures to facilitate their accountability should be in place, including transparency arrangements with respect to the nature and performance of their responsibilities.

There is a balance to be struck as to the level of detail of corporate governance contained in statutory law. There are risks of excessive inflexibility, and associated compliance and efficiency costs, if statutory law contains an excessive degree of prescription. The level of prescription will depend in large measure on the extent to which non-statutory frameworks operate to promote sound corporate governance. All else being equal, statutory law can be less
prescriptive and detailed where sound corporate governance practices are fostered by the
evidence of strong market disciplines, competitive markets, a corporate governance “culture”,
and robust financial disclosure requirements, among other factors. Conversely, if these
“environmental” factors are not strongly present, then this may suggest the need for a greater
degree of prescription of corporate governance requirements in statute law.

**Developing a Corporate Governance Culture – The Role of Corporate Governance Principles**

Another mechanism for promoting sound corporate governance in the financial sector is by the
couragement of a corporate governance culture through codes of conduct and principles of
good practice. The development of corporate governance principles or guidelines can play a
significant role in promoting greater awareness and adoption of sound corporate governance
arrangements. Corporate governance principles may be developed by industry associations,
institutes of directors, government authorities, or other bodies, such as stock exchanges.

*International initiatives.* At an international level, a number of agencies have promulgated
principles on corporate governance that can assist countries and private agencies in designing
their own corporate governance codes of practice. The OECD Principles on Corporate
Governance, the principles developed by the Commonwealth Association for Corporate
Governance (CACG) and the work developed by the World Bank (and by regional forums such
as APEC) all provide guidance in these areas. The Basel Committee on Banking Supervision
has also distilled some guidance material on corporate governance as it applies to banking in its
paper *Enhancing Corporate Governance in Banking Organisations.*

The corporate governance principles developed by the OECD and the Basel Committee on
Banking Supervision can be accessed on their web sites: [http://www.oecd.org](http://www.oecd.org) and
http://www.bis.org respectively. In addition, the World Bank (including the Global Corporate
Governance Forum formed by the OECD and World Bank) has made information available on
corporate governance, including internet access to information made available by the
Commonwealth Association for Corporate Governance. The World Bank’s web site is
released material on corporate governance. This can be accessed on the APEC web site:

The corporate governance principles developed by the Commonwealth Association for
Corporate Governance are attached to this report.

*General corporate governance principles.* Drawing on the work undertaken by the OECD,
World Bank, CACG and the Basel Committee on Banking Supervision, a number of generic
corporate governance principles can be identified, including the following:

- Directors should have the skills and experience necessary to perform their role effectively,
  and should have a sound understanding of the nature of the company’s business and its
  risks.

- Directors should not accept a position on the board if they have conflicts of interest that
  would significantly compromise their ability to perform their duties.

- The strategic objectives of the company need to be clearly specified and the risk/return
  trade-offs need to be well understood and articulated.
Directors need to satisfy themselves that the senior management team has the necessary skills and experience to perform their functions effectively, in the best interests of the company, and should ensure that there are structures in place for monitoring the performance of management.

There should be a clear specification of rights for company shareholders, including rights relating to access to information, participation in general meetings, and the election of directors.

There should be a clear specification of the powers, duties and obligations of directors, including the need for directors to act in good faith, with due diligence and skill, and in the best interests of the company.

Directors should be obliged to satisfy themselves of the adequacy of their company’s systems for identifying, monitoring and managing risks and that those systems are being applied effectively at all times. Effective internal audit arrangements, overseen by an Audit Committee of the board, should be maintained.

The board should receive all the information they need in order to satisfy themselves that the company’s affairs are being conducted in a manner consistent with the business objectives of the company and that all risks are being effectively managed.

There should be structures to require a strong degree of accountability of directors to shareholders and other stakeholders of the company, and of management to directors. This includes the need for arrangements to be in place to facilitate effective communication with all categories of stakeholder, taking into account the information needs and rights of the stakeholders.

The board should set key performance indicators for the chief executive and senior management team and establish a system for effectively monitoring performance.

The board of directors should be subject to transparent rules governing conflicts of interest and related party lending, and that board decisions in these areas be disclosed.

There should be robust financial disclosure and external auditing arrangements. In the context of banking, disclosure requirements need to be relatively specific, requiring regular public disclosure of a bank’s financial performance, capital position, asset quality, risk exposures and risk management systems. Directors should be held to account for the veracity of disclosures.

Specific principles for corporate governance in banking. The above principles are applicable to a wide range of corporate entities, and equally apply to banks. However, in the case of banking, some corporate governance principles are particularly important, given the importance of banks to the stability of the financial system and the wider economy, and therefore the need for effective management of banking risks. In addition, two specific features of banking suggest the need for a more intensive focus on corporate governance than might be necessary in some other sectors of the economy: their reliance on debt funding and the confidence of creditors; and the complexity of their risks. These points are elaborated on below.
More than in most corporate entities, banks and many other types of financial institution are critically reliant on maintaining the confidence of depositors and other creditors. The economic welfare, and indeed survival, of a bank is very much dependent on maintaining depositor and other counterparty confidence. Therefore, the directors and senior management of banks could be said to have a special duty of care to their bank’s depositors and other creditors – the creditors are extremely important stakeholders in the bank. A bank’s corporate governance arrangements could be expected to reflect this duty of care to creditors in a number of ways, such as in the management of conflicts of interest between shareholders and creditors, in the nature of financial disclosures made to creditors (and others) and in the nature of risk management systems.

Looking after creditors’ interests and managing conflicts of interest between shareholders and creditors. The importance of creditors to a bank’s welfare suggests the need to have corporate governance and risk management arrangements that enable the bank to maintain strong customer relationships and confidence in the bank’s financial position. Among other factors, this suggests the need for directors and senior management to be attentive to the possible conflicts that might arise between the interests of the bank’s shareholders and creditors. In general, shareholders’ interests are best served by maximising the long term present value of the bank, although very often there is a tendency to focus on augmenting the short term profit of the bank rather than necessarily focusing on the longer term position. Creditors’ interests are best served by the bank taking a somewhat more cautious approach to the management of its risks, such that creditors can be assured that their funds will be available in full upon maturity or on demand.

In practice, these conflicts can be managed effectively by adopting appropriately cautious management strategies, yet still maintaining an acceptable level of profitability. However, directors and senior management need to be aware of the potential for conflicts of interest to occur and to have structures in place to manage these conflicts effectively. These might include having structures to manage potential conflicts:

- between adopting higher versus lower risk lending strategies,
- between maximising short term profit results versus longer term stability,
- over the appropriate level of capitalisation of the bank, and
- in respect of the appropriate level of connected exposures (to the parent company, other shareholders, and associated parties) and distributions to shareholders. As discussed earlier in this paper, large exposures to connected parties pose a risk of loan loss and contagion with other parts of the corporate group, and therefore need to be carefully controlled.

The structures needed to attend to these potential conflicts will vary depending on a bank’s particular circumstances, but may include risk management systems that identify where the particular conflicts could arise and prompt management and directors to satisfy themselves that the conflicts have been appropriately resolved. It is also likely that the inclusion of some independent and non-executive directors on the board of a bank would assist in managing the conflicts between the interests of shareholders and the interests of the bank’s creditors. In particular, directors that are not connected with the parent entity or associated companies (where the bank is controlled or significantly influenced by a single entity or group of entities) are likely to be better placed to identify potential conflicts between the shareholders and creditors’ interests and to ensure that appropriate controls are in place to manage these conflicts. Independent, non-executive directors can also bring fresh perspectives and scrutiny to many
aspects of a bank’s business operations, including risk management systems, in ways that can supplement (and, if necessary, challenge) the views of senior management, executive directors and controlling shareholders.

**Need for effective risk management.** Banks also differ from most other companies in terms of the nature and range of their business risks, and the consequences if these risks are poorly managed. Banks face a wide range of risks, many of them complicated in nature, including credit risk, exposure concentration risk, connected exposure risk, interest rate risk, exchange rate risk, equity risk, legal risks, operational risks, defalcation risks, liquidity risks, reputation risks, payment system interface risks and business continuity risks. If these risks are poorly identified and managed, they expose the bank to the potential for financial collapse, particularly given the fact that most banks operate on a thin layer of capitalisation and have substantial maturity mismatches in their balance sheet. Therefore, banks need corporate governance structures that promote effective identification, monitoring and management of all material business risks. These structures may include:

- well developed and tested risk management systems and internal controls;
- training programmes for staff responsible for risk management, so that they have a well developed understanding and detailed technical knowledge of risks and the means by which they can be managed;
- training programmes for directors and senior management to enable them to have a robust understanding of the nature of the bank’s business, the nature of the risks, the consequences of risks being inadequately managed, and an appreciation of the techniques for managing the risks effectively;
- robust internal audit procedures, with appropriate reporting lines to the CEO or directors, and with oversight by the Audit Committee of the board;
- a structure which requires regular reporting to senior management and the board on the nature and magnitude of the risks being carried by the bank and the structures in place to control these risks, including a regular assurance to the board that all risk management systems and internal controls are being properly applied at all times;
- signed attestations by each director, in a public disclosure statement issued by the bank, that the director is fully satisfied that all the bank’s material business risks are being effectively identified, monitored and managed, and that the systems in place to achieve this are operating effectively at all times; and
- a policy requiring the bank’s risk management systems and internal controls to be subject to periodic external review, and for the results of the review to be reported to the board.

**Compliance with regulatory requirements.** Banks also need to comply with a large number of regulatory requirements, including prudential requirements, taxation rules, various reporting obligations and the like. There is therefore a need for the corporate governance framework to include systems for ensuring that all statutory and regulatory requirements are being complied with, and to highlight potential or actual breaches if and when they occur.
High Quality Financial Disclosure

An essential complement to sound corporate governance is the implementation of robust financial disclosure requirements for corporates and financial institutions. Financial disclosure is essential as a means of strengthening the accountability of directors and senior management and enhancing the incentives for risk management. It is also essential if market participants and observers – particularly the larger creditors of banks, financial news media, financial analysts and rating agencies – are to effectively monitor the performance and soundness of financial institutions and exercise appropriate disciplines on those institutions which do not perform well or fail to meet acceptable prudential standards. Financial disclosure is also essential if smaller creditors, including depositors of banks, are to have any chance of protecting their own interests, particularly in the absence of deposit insurance.

In recognition of the importance of high quality financial disclosure, this issue is receiving considerable attention in various international forums. This includes the International Accounting Standards Committee (which has developed a set of international accounting standards), IOSCO (which is developing international disclosure standards for cross-border listing requirements), and the Basel Committee on Banking Supervision (which is developing transparency principles for application to banks). Moreover, the IMF and World Bank are placing greater emphasis on the need for countries to develop sound disclosure practices, as reflected in the broader focus of IMF Article IV consultations and the recently introduced Financial Sector Assessment Programme. The IMF/World Bank Reports on Observance of Standards and Codes (ROSC) is another process that may assist in encouraging the implementation of effective financial disclosure requirements.

Although the nature of financial disclosure and accounting standards will vary from country to country, depending on institutional and legal arrangements, some broad principles can be identified. These include the following principles:

- An effective set of disclosure requirements will need to be underpinned by robust accounting standards. These standards should desirably conform to international standards, although national modifications may well be appropriate. In particular, it is essential for accounting standards to set out meaningful frameworks for measuring credit exposures – preferably based on market values rather than on historic cost or other notional valuations. Accounting standards should also prescribe meaningful and reasonably specific rules for the recognition of income and expenses, for the recognition and classification of off-balance sheet exposures, and for the classification of assets and liabilities. In general, accounting standards should require the disclosure of financial information on the basis of economic substance rather than on the basis of accounting or legal contrivances.

- External audit should be conducted by a fully independent auditor, whose business connections with its client should not be such as to compromise the auditor’s objectivity and independence.

- Financial disclosures should be subject to rigorous external auditing requirements, based on a set of auditing guidelines promulgated by an appropriately qualified standard-setting body. International audit standards, developed by the International Federation of Accountants, provide a framework for assisting countries to develop national auditing requirements. In some cases, banking supervisory authorities may supplement the standard auditing requirements with auditing requirements for unique application to banks. Modifications can sometimes include:
- a requirement for banks to undergo more frequent external audit than is normally required of public companies (e.g., six monthly or quarterly);

- a requirement that particular prudential disclosures are audited (in addition to the usual financial disclosures) – e.g., capital adequacy, exposure concentration, connected lending, market risk disclosures, etc;

- a requirement that a bank’s risk management systems are periodically subject to external audit or some other external review, sometimes under the overview of the supervisory authority;

- a requirement that the appointment of a bank’s auditor is subject to the approval of the supervisory authority;

- a requirement that the bank periodically change its auditor, in order to reduce the risk of “auditor capture”;

- a requirement for the auditor to report to, or meet with, the supervisory authority; and

- a requirement obliging the auditor to report any concerns they may have to the supervisory authority.

- As a general rule, disclosures of financial information are more useful if they are made with a reasonable degree of frequency – e.g., six monthly or quarterly.

- Disclosure of financial and risk-related information by banks should be in respect of the bank and the consolidated group. In some cases, holding company disclosures may also be appropriate.

- The information required to be disclosed will vary depending on the type of entity making the disclosures and the particular needs of the jurisdiction. As a general rule, however, banks could be expected to disclose:

  - capital, disaggregated by type of capital, and the percentage of capital relative to credit exposures, possibly using the Basel Capital Accord as the measurement framework (or a credible alternative);

  - the bank’s credit rating and any recent changes to the rating. It may also be appropriate in some cases to require disclosure of the parent entity’s credit rating and any recent changes to its rating;

  - comprehensive and detailed information on the balance sheet, income statement and off-balance sheet obligations;

  - exposure concentration, in terms of exposures to individual counterparties or groups of associated counterparties relative to the bank’s capital, desirably on a peak end-of-day basis;

  - exposures to particular economic sectors or industries;

  - detailed information on asset quality, including the amount of non-performing and restructured loans and the level of specific provisioning in relation to such loans. Disclosure requirements should desirably provide guidance on the basis upon which asset quality is reported and provisioning is determined;
- information on market risk (i.e., interest rate risk, exchange rate risk, and equity risk), desirably using the Basel Committee’s market risk methodology or a credible alternative;

- information on related party exposures, desirably on a peak end-of-day basis;

- information on the nature of a bank’s funds management, securitisation, and other fiduciary business, including details of funding provided by the bank to these business activities and the structures in place to limit contagion between the funds management activities and the core business of the bank;

- information on the bank’s systems for managing its business risks, including information on the nature of its internal control systems, internal audit arrangements and any other arrangements it has for an external review of the adequacy of its risk management systems and internal controls; and

- disclosure of the names, qualifications, and experience of directors and senior management.

An important element of a well-designed disclosure regime is the accountability it can bring to the board of directors. This recognises the vital role which bank directors play in overseeing, and taking ultimate responsibility for, the prudent management of all of their bank’s business risks. In order to sharpen the accountability of a bank’s directors, banks and other financial institutions could usefully be required to regularly disclose:

- the nature of any conflicts of interest that individual directors or senior managers may have;

- the board’s rules for handling directors’ and managers’ conflicts of interests; and

- attestations signed by each director as to whether they are satisfied that the bank’s/financial institution’s risks (itemised by specific type of risk) are being adequately identified, monitored, and controlled at all times.

For any disclosure regime to be effective, it must be enforced. There should be a competent authority charged with monitoring compliance with disclosure requirements and equipped with the powers to enforce compliance where appropriate. The authority should be subject to effective transparency and accountability structures.

There should be a prescribed set of penalties for non-compliance with disclosure requirements. Penalties for non-compliance should be clearly specified, and should apply not only to the financial institution itself, but also to its directors and other key officers. Penalties might include fines, imprisonment, and civil liability (e.g., where directors or senior management may be held personally liable for creditors’ losses where a bank fails, and creditors can establish that they had relied on disclosures issued by the bank and that these disclosures had been false or misleading).

In introducing a disclosure regime, it is also important to ensure that relevant audiences are well educated about the objectives of financial disclosure and the nature of the disclosure arrangements, so that they can make the most efficient use of financial disclosures. This might suggest providing explanatory material to financial journalists and analysts, and encouraging the financial news media to take a keen interest in the disclosures issued by banks and other financial institutions. And, it might suggest the
need for explanatory material to be provided to depositors, to assist them to interpret a 
bank’s disclosures.

**Strengthening Market Disciplines**

It is increasingly being recognised that market disciplines can play an important role in 
promoting financial system stability and in encouraging the maintenance of sound corporate 
governance and risk management practices. Banks and corporates are more likely to be 
attentive to risk management in an environment where poor risk management and financial 
performance are penalised by the market, and strong risk management and financial 
performance are rewarded by the market. In the longer term, robust market disciplines are 
likely to enhance financial stability and efficiency by strengthening the incentives for the 
efficient management of risks and by weeding out poor performers.

Unfortunately, various government policies and interventions have dulled the effectiveness of 
market disciplines in many countries. These can include:

- government ownership of banks and corporates;
- government guarantees of banks and corporates or implicit government support 
  arrangements;
- poorly designed deposit insurance arrangements;
- responding to bank failures in ways that insulate depositors and other creditors (and 
  sometimes even) shareholders from losses;
- uncompetitive financial markets; and
- poorly developed capital markets.

In order to strengthen market disciplines on the financial system and corporate sector, and 
thereby encourage the development of sound corporate governance practices, a number of 
policy options can be considered. Options include:

- **Creating ownership structures that strengthen the disciplines on banks.** One of the 
  most effective ways of strengthening market disciplines in the banking system (and 
  encouraging higher quality management within banks) is by privatising state-owned 
  banks. The privatisation of government owned financial institutions offers a number of 
  potential benefits. These include: reduced fiscal risk associated with government 
  ownership of financial institutions, strengthened market disciplines on the institution in 
  question, sharper incentives for sound risk management within the institution and the 
  likelihood of stronger corporate governance arrangements being implemented (provided 
  that the institution is sold to a sound parent bank or corporation).

In order for privatisation to bring these benefits, certain prerequisites must first be met, 
such as the implementation of appropriate corporate governance arrangements, ensuring 
that the financial institution is in a sound condition and that there are appropriate 
regulatory and disclosure arrangements in place for the financial system. And it is 
essential, of course, to ensure that the new owner of a bank is suitable – ie that they have 
experience and expertise in banking business, that they will supervise the bank
appropriately and that they can demonstrate a reasonable commitment, and the necessary substance, to stand behind the bank should it get into difficulty.

If privatisation of state owned banks is not a viable option, then it is essential that sound corporate governance arrangements are established, that the board comprises directors with suitable qualifications and experience, that the bank operates according to appropriate commercial criteria and is not used as an instrument of broader public policy and that the government, as owner, establishes structures for effectively monitoring and overseeing the bank and its risk management processes.

- **Removing or limiting government guarantees of banks and corporates.** Another option for reducing moral hazard risks and strengthening market disciplines on the financial and corporate sectors is to remove or limit government guarantees or implicit support arrangements for individual banks. As with privatisation, however, the removal of government guarantees needs to occur at a time when the banking system is in a sound condition and when structures have been bedded down to promote robust risk management. Once this has been achieved, the removal of government guarantees and minimisation of implicit support arrangements will assist in sharpening the disciplines on the banking system and thereby encourage the maintenance of effective governance arrangements.

- **Promoting a contestable and competitive financial system.** Another important ingredient in promoting sound corporate governance via market disciplines is to encourage competitiveness within the financial sector, by increasing the contestability and competitiveness of financial markets. This can be done both by opening up the financial system to new participants (both domestic and overseas) and by promoting a competitively neutral regulatory framework so that the “playing field” is relatively level. In particular, opening up the financial sector to foreign banks can assist in promoting a more competitive, innovative and mature financial sector and can enhance the development of a corporate governance culture and risk management skills in the financial sector. International banks of high quality can bring an infusion of skills and experience in corporate governance and risk management, encouraging existing market participants to adopt improvements in their own systems.

However, it is important to ensure that liberalisation of the financial sector is accompanied by other measures to strengthen the financial system, so that increased competitiveness does not result in instability. For example, prior to opening up the banking system to new banks, it is essential to ensure that the banking system is subject to high quality disclosure and corporate governance requirements, effective banking supervision arrangements and other structures to promote effective risk management. It is also essential that the liberalisation process occurs in the context of a stable economic environment, where economic policies are effective in minimising asset price volatility, where there are few regulatory distortions to relative prices, and where macroeconomic policy settings are sustainable and credible.

- **Financial safety nets for bank depositors.** Inappropriately designed financial safety nets, including deposit insurance arrangements or selective government guarantees of customer deposits, can reduce the effectiveness of market disciplines on the banking system, and reduce the incentives for effective corporate governance and risk management. This is particularly the case where financial safety nets are open-ended (with no cap on the amount of insurance) and risks are not adequately factored into the pricing of deposit insurance.
An important challenge for governments is therefore to structure financial safety nets in ways that minimise moral hazard and strengthen market disciplines on financial institutions, while still ensuring that financial distress situations are effectively resolved. In this context, a number of issues arise, including:

- Consideration of whether the benefits associated with deposit insurance necessarily outweigh the longer term costs. In this regard, there needs to be an assessment of whether, in the absence of deposit insurance, banks might have incentives to hold higher levels of capital and better manage their risks than is the case where depositors are protected by insurance, thereby enhancing the soundness of the financial system.

- If deposit insurance is considered to be necessary, then there needs to be a careful assessment of the design features that would assist in maintaining market disciplines on banks and in reducing moral hazard risks. These might include:
  - setting relatively low caps on deposit insurance, so that only small deposits are protected, thereby retaining incentives for larger depositors to exercise appropriate scrutiny over their banks;
  - ensuring that the caps are not able to be circumvented, such as by splitting deposits into small parcels or spreading deposits over a number of banks;
  - creating some form of co-insurance – whereby depositors remain exposed to the possibility of loss on a proportion of their deposit;
  - ensuring that insurance is priced to take into account the risk profile of the bank in question to the extent practicable; and
  - ensuring that the directors and management of banks remain fully responsible for the management of risks within their bank, and that they are held accountable in the event that their bank fails.

In recognition of the important role that deposit insurance can play in promoting financial stability, and of the risks associated with poorly designed insurance arrangements, much work is being undertaken internationally to research and promote a greater understanding of deposit insurance issues. In this context, the Financial Stability Forum has formed a working group to undertake research on deposit insurance and assess the benefits and risks associated with different forms of deposit insurance arrangements. The working group is also evaluating the desirability of setting out international guidance on deposit insurance, with a view to developing appropriate guidance material to assist countries in the design and implementation of deposit insurance. The IMF and World Bank are also involved in promoting a greater understanding of deposit insurance issues and in advising on the design and implementation of insurance arrangements.

**Bank failure management.** It is equally important that, in responding to bank failures, central banks and regulatory agencies try to preserve disciplines on the failed bank as much as possible, so as to reinforce the incentives for sound corporate governance in survivor banks. This suggests the need to ensure that shareholders and subordinated creditors of the failed bank bear the full extent of losses attributable to them (rather than being “bailed out” by the government). To the extent practicable, it also suggests that there is benefit in ensuring that depositors and other senior unsecured creditors of a failed bank bear their fair share of losses. This suggests the need for the regulatory authorities to explore failure management options that would enable the authorities to respond to a
bank failure in such a way as to minimise flow-on effects to the financial system, yet also ensure that depositors and other creditors bear a substantial proportion of any losses (rather than these being absorbed by the tax payer). And, within the constraints of the law, it is also important to ensure that the directors and senior management of the failed bank are held to account for the bank failure, to the extent that the failure can be attributed to actions taken, or not taken, as the case may be, by these parties.

**Capital markets.** Capital markets have an important part to play in promoting sound corporate governance in the banking sector. Equity and debt markets are likely to encourage the development of sound corporate governance and risk management practices through a number of channels, including the following:

- Capital markets may impose listing rules on market participants, including requirements relating to corporate governance and financial disclosure. These can assist in encouraging banks and other market participants to adopt and maintain high standards in their corporate governance arrangements.

- Equity and debt markets provide investors with a structured means of obtaining information on banks, making them better informed about the quality of banks’ risk management and business strategies. In turn, this enables investors to reward well managed companies with relatively inexpensive pricing in the debt and equity markets, and to penalise poorly managed companies with higher pricing (and, in the extreme, cutting off a company’s access to market funding).

Therefore, an important means of encouraging sound corporate governance and risk management practices in the banking and corporate sectors is to encourage the development of efficient capital markets. Among other matters, this will necessitate:

- well developed commercial law, enabling parties to contract reliably with one another and enabling securities to be bought and sold in a reliable manner;

- mechanisms to facilitate enforcement of commercial law, including a well resourced judiciary and court system;

- effective financial disclosure arrangements applicable to issuers of securities, based on robust and enforceable accounting and auditing standards;

- the need to minimise pricing distortions arising from tax on financial transactions and other policies;

- the need to ensure that the regulatory and supervisory framework is effective and succeeds in reducing systemic risk; and

- there should be a reliable and efficient means to transfer securities from seller to buyer and to settle the associated financial obligations. Settlement systems and other aspects of market infrastructure should be governed by clear and unambiguous rules and procedures that are effectively enforced.

A number of international agencies have developed frameworks for assisting countries to develop their equity and bond markets, particularly the World Bank and the regional development banks. In addition, APEC has produced a substantial report setting out a series of principles to aid countries in the development of bond markets.
Prudential Regulation and Supervision

Prudential supervision can also play an important role in encouraging the adoption of sound corporate governance arrangements in the banking sector. The nature of the supervisory arrangements will vary depending on a range of factors, including a country’s institutional arrangements, the structure of the banking system, the nature of banking risks and the strength or otherwise of market disciplines. Depending on these factors, banking supervision will generally involve elements of:

- imposing minimum prudential requirements on banks (such as minimum capital ratios and exposure caps);
- establishing financial and prudential reporting requirements for banks;
- monitoring the financial and prudential condition of banks;
- consulting with banks on their business operations and risk management practices;
- detecting signs of incipient financial distress; and
- maintaining a capacity to intervene in the banking system where there is an indication of emerging financial distress, and taking steps to minimise systemic disruption.

In this context, one of the important roles of banking supervision is to promote the adoption and maintenance of robust corporate governance and risk management practices in the banking sector. There are various ways this can be done, and the appropriate method will vary depending on, among other matters, the extent of market disciplines operating in the economy and financial system. The options can include:

- Encouraging bank directors and senior management to take responsibility for satisfying themselves that their bank has effective systems for managing all material business risks and that those systems are being applied at all times. One way of encouraging this is for the supervisory authority to require bank directors and senior management to sign regular statements attesting to the effectiveness of risk management systems, internal controls, internal audit arrangements and related matters, and to hold them responsible if it transpires that those attestations transpired to be misleading or false.

- Given that market disciplines and robust financial disclosure requirements can go a long way towards encouraging the adoption of sound corporate governance, one of the most productive means by which supervisory authorities can promote high quality corporate governance and risk management practices is by promoting robust disclosure arrangements and encouraging the development of structures to promote market disciplines in the financial system.

- Encouraging or requiring banks to have their corporate governance arrangements and risk management systems subject to periodic external review by external auditors or consultants.

- Requiring banks to maintain and publicly disclose a credit rating from a reputable international credit rating agency, so as to provide an additional degree of external scrutiny of each bank’s corporate governance and risk management capacity.
Providing guidelines on corporate governance arrangements and risk management systems and encouraging or requiring banks to comply with the guidelines, or using the guidelines as a framework for periodic assessments of the adequacy of corporate governance arrangements.

Holding periodic consultations with bank directors to discuss banking risk issues and other matters relating to the governance of their bank.

Promoting capacity building in the financial sector in the areas of corporate governance and risk management systems, including possibly by sponsoring training programmes for bank directors and staff and encouraging dialogue on these issues.

Although there may be circumstances where a supervisory authority needs to play an active role in encouraging banks to adopt robust corporate governance arrangements, particularly where there may be little infrastructure and market discipline to encourage sound governance practices, there are major risks in the supervisory authority becoming too closely involved. It is important that the supervisory authority makes a clear distinction between its role and that of a bank’s directors and senior management. The function of the supervisory authority is to promote structures to encourage banks to maintain sound corporate governance arrangements; it does not have responsibility for implementing and maintaining governance structures or for managing risks – these are the responsibilities of the bank’s directors and senior management.

Capacity building

In developing and emerging economies, a lack of relevant skills and experience can seriously impede the implementation and maintenance of sound corporate governance. This is true of various participants in the corporate governance matrix, including directors, senior management, lower levels of management, risk managers and regulators. Therefore, in addition to developing the necessary frameworks for promoting corporate governance, such as those discussed earlier in this paper, it is also necessary to ensure that structures are in place to build capacity in developing and emerging economies. This can be achieved through a number of mechanisms, including:

- training programmes for directors, managers, staff and regulators, particularly in relation to corporate governance, disclosure and risk management issues;
- secondment arrangements, whereby staff at various levels of banks and other corporates (and regulatory agencies) can gain exposure to corporate governance practices in banks, companies and regulatory agencies, as appropriate, in countries with high governance standards; and
- technical assistance programmes, including those sponsored by the World Bank and regional development banks.

Leading by example

An important element in promoting sound corporate governance in the banking sector is through “leadership by example” within central government and regulatory agencies. The adoption of robust corporate governance practices is likely to be greater where central
government and the regulatory agencies responsible for the financial sector lead the way by maintaining conspicuously effective governance, transparency and accountability arrangements within their own operations. This suggests the need for government, government agencies and regulatory bodies to be subject to (among other matters):

- transparent arrangements (in the case of appointed positions) that require appointees to be suitably qualified and experienced, such that they have the ability to perform their duties effectively;
- transparent and rigorous internal governance requirements, including measures to promote effective risk management, internal audit, and management of conflicts of interest;
- appropriate financial disclosure requirements, based on professional accounting standards;
- effective external audit requirements, where the audit arrangements comply with standard professional auditing principles; and
- a rigorous accountability framework, requiring disclosure of public policy objectives; clear assignment of responsibility and powers for the fulfilment of objectives; disclosure of performance; disclosure of remuneration arrangements; a structure for facilitating external monitoring of performance; and credible mechanisms for removing officials for non-performance.

The importance of central government and its agencies being subject to effective corporate governance, transparency and accountability arrangements is being increasingly recognised. The IMF and World Bank are encouraging the adoption and maintenance of sound public sector agency governance and accountability frameworks through various measures, including technical assistance programmes, seminars, and the Financial Sector Assessment Programme. As part of this process, the IMF has released two public policy transparency standards: the Code of Good Practices on Transparency in Monetary and Financial Policies and the Code of Good Practices on Fiscal Transparency. Both of these standards set out general principles on the transparency of monetary, fiscal and financial regulation policies, encouraging the clear articulation of policy objectives, policy arrangements and performance. The code relating to monetary and financial policy also sets out basic principles for the governance and accountability of the agencies responsible for monetary policy and financial sector regulation.

**Conclusion**

This paper has argued that effective corporate governance and risk management practices are essential for the promotion of financial stability. The paper has identified a number of ways in which sound corporate governance and risk management practices can be encouraged, including:

- the development of effective corporate law and the legal infrastructure to enforce it;
- measures to promote a corporate governance culture, including through the development of corporate governance principles and guidelines and capacity building initiatives;
promoting high quality accounting and auditing standards, including effective enforcement of disclosure requirements, with an emphasis on holding directors to account for the truth and fairness of disclosures issued by their bank;

policies to strengthen the market disciplines on the banking system, including through the nature of bank ownership structures, opening up banking systems to reputable overseas banks and introducing competition to the financial system; and

effective supervisory techniques to encourage the adoption and maintenance of sound corporate governance and risk management practices.
APPENDIX

Summary of Corporate Governance Principles – Developed by Commonwealth Association for Corporate Governance

This appendix sets out the 15 corporate governance principles released by the Commonwealth Association for Corporate Governance, contained in their report entitled: CACG Guidelines: Principles of Corporate Governance in the Commonwealth, issued in 1999.

The Board of Directors should:

- **Principle 1** - exercise leadership, enterprise, integrity and judgement in directing the corporation so as to achieve continuing prosperity and to act in the best interest of the business enterprise in a manner based on transparency, accountability and responsibility;

- **Principle 2** - ensure that through a managed and effective process board appointments are made that provide a mix of proficient directors, each of whom is able to add value and to bring independent judgement to bear on the decision-making process;

- **Principle 3** - determine the corporation’s purpose and values, determine the strategy to achieve its purpose and to implement its values in order to ensure that it survives and thrives, and ensure that procedures and practices are in place that protect the corporation’s assets and reputation;

- **Principle 4** - monitor and evaluate the implementation of strategies, policies, management performance criteria and business plans;

- **Principle 5** - ensure that the corporation complies with all relevant laws, regulations and codes of best business practice;

- **Principle 6** - ensure that the corporation communicates with shareholders and other stakeholders effectively;

- **Principle 7** – serve the legitimate interests of the shareholders of the corporation and account to them fully;

- **Principle 8** – identify the corporation’s internal and external stakeholders and agree a policy, or policies, determining how the corporation should relate to them;

- **Principle 9** – ensure that no one person or a block of persons has unfettered power and that there is an appropriate balance of power and authority on the board which is, inter alia, usually reflected by separating the roles of the chief executive officer and chairman, and by having a balance between executive and non-executive directors;

- **Principle 10** – regularly review processes and procedures to ensure the effectiveness of its internal systems of control, so that its decision-making capability and the accuracy of its reporting and financial results are maintained at high levels at all times;

- **Principle 11** – regularly assess its performance and effectiveness as a whole, and that of the individual directors, including the chief executive officer;
Principle 12 – appoint the chief executive officer and at least participate in the appointment of senior management, ensure the motivation and protection of intellectual capital intrinsic to the corporation, ensure that there is adequate training in the corporation for management and employees, and a succession plan for senior management;

Principle 13 – ensure that all technology and systems used in the corporation are adequate to properly run the business and for it to remain a meaningful competitor;

Principle 14 – identify key risk areas and key performance indicators of the business enterprise and monitor these factors;

Principle 15 – ensure annually that the corporation will continue as a going concern for its next fiscal year.