

## Instruction Sheet – Financial Institutions

### The Governance of Financial Institutions

Investments in financial institutions provide the largest single sector for IFC's business, constituting nearly a third of IFC's portfolio. Therefore, it is important that the special governance risks and complexities posed by financial institutions are analyzed by IFC. Commercial banks and other deposit-taking financial institutions pose the greatest risks: first, since banks take large amounts of risk-bearing obligations on their books, weak internal controls and accountability can cause urgent and rapid crises; second, the collapse of a bank will usually destroy value for its public depositors, not just shareholders, and may even require a costly bail-out by the fiscal authorities; and, third, there is the systemic risk that the collapse of a single bank can undermine the entire banking system. Because of these special governance risks, banks are usually required by law or regulation to have certain specific governance structures and reporting standards. Although commercial banks are the main focus of IFC's financial institutions paradigm, most of these governance issues also apply to all other types of financial institutions that IFC invests in, including *inter alia* housing finance institutions, microfinance institutions, securities firms and insurance companies.<sup>1</sup>

### Using the CG Tools

There are seven key CG Tools that are used for analyzing the governance of financial institutions and the other types of companies. The Instruction Sheets, Progression Matrices, Information Request Lists (which depending on the client and project characteristics can be the DDR Report Generator<sup>2</sup> or the FGA Tools) and the Sample CG Improvement Programs have been adapted for the Financial Institutions paradigm. The explanatory note "Why Corporate Governance?", the Model Independent Director Definition and the Supervision Checklist are applicable across all five paradigms without any adaptations.

- 1) Instruction Sheet – Financial Institutions** The purpose of this Instruction Sheet is to describe each of the key CG Tools, how they should be used and who should be interviewed in the course of either a Full Governance Assessment (FGA) or a Due Diligence Review (DDR).. (A full description of the Step-by-Step Process for analyzing the governance of companies is provided in the section of the website "Applying the IFC Methodology".)
- 2) Why Corporate Governance?** This note explains IFC's approach as value-added for clients. *This explanatory note should be given to the client at the earliest opportunity in the pre-appraisal.*
- 3) Progression Matrix – Financial Institutions** The Progression Matrix relates the five areas of governance (Commitment to Good CG, the Board of Directors, Control Environment and Processes, Transparency and Disclosure and Shareholders Rights) to four levels of achievement. The use of a matrix framework emphasizes the importance of ongoing improvements in the governance practices of clients, rather than trying to apply rigid and static minimum standards. In particular, the Progression Matrix allows clients to assess the governance of their own institution against a simple framework. *The Progression Matrix should be given to the client at the earliest opportunity in the pre-appraisal.*
- 4) Information Request List – Financial Institutions** This list of questions and requests for documentation forms the basis for the Corporate Governance Review of an IFC client. The Information Request List is organized along the same lines as the five areas of governance in the Progression Matrix. *For a FGA the Information Request List should be circulated to the financial institution at least three weeks in advance of the on-site visit.* The institution should identify a single officer who will be charged with responding to the Information Request List by providing brief written answers of one or two paragraphs to each of the questions and deliver these to IFC *prior to* the on-site corporate governance analysis. For the DDR, the

<sup>1</sup> The financial institutions paradigm includes questions that are most applicable to financial institutions that are also publicly listed. Therefore, it is *not* necessary to also apply the listed company paradigm to listed financial institutions. For those financial institutions that are not listed, some of the questions on the Information Request List may not be applicable and can be edited out. For listed financial institutions in Supervisory Board Systems or in the People's Republic of China, the corresponding information request lists for listed companies in these governance systems can be used as extra resources.

<sup>2</sup> The Report Generator is an integrated tool that has the 5 key CG risks, questions for the client, documents to requests and the mitigating features to identify in producing an appropriate Decision Book report with recommendations.

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investment officer must collect the required information from the documents or from interviews during the appraisal. If the IO elects to send a specially prepared DDR information request ahead of the site visit, an amended “questions-only” version of the Report Generator should be sent to the client. Discussions relevant to IFC’s understanding of the governance of an institution will arise throughout the appraisal and diligence process. Therefore, IFC staff are encouraged to edit the information request (FGA or DDR) as necessary before sending it to the client, so as to avoid duplication.

- 5) **Model Independent Director Definition** Perhaps the most frequent governance recommendation is to increase the Board’s independence from both the management and the controlling shareholders. However, to achieve genuine Board independence, it is crucial to carefully define what it means for directors to be “independent”. This Model Independent Director Definition is often used during discussions with the client to clarify the assessment of the current Board and its future needs.
- 6) **Sample CG Improvement Program or Sample Decision Book Section (for DDRs) – Financial Institutions** A FGA results in the drafting and negotiation of a Corporate Governance Improvement Program (CGIP) to be implemented by the client. This CG Improvement Program should always be tailored to the circumstances and priorities for the institution. However, these Sample CG Improvement Programs give a good idea of what has been negotiated with clients in the past and, therefore, they can be used as a reference point in the drafting process. The DDR always generates a section for the Decision Book and sometimes this will include recommendations for improvements. This sample DDR Decision Book Section provides a useful reference point for the IO’s use.
- 7) **Supervision Checklist** The Supervision Checklist provides a list of key issues that should be considered by investment staff while supervising IFC investee companies and, in particular, those companies undertaking CG Improvement Programs.

### Corporate Governance Interviewees

To carry out a thorough corporate governance review (FGA or DDR), IFC Staff need to have direct discussions with people who play a variety of governance roles in the financial institution. A list of the people who would normally be interviewed is provided below. However, financial institutions may differ significantly in how they apportion responsibilities and in the titles they use for different positions, so it is important that IFC staff meet with those who, as a practical matter, are responsible for the principal corporate governance functions, irrespective of their job titles.

- Representatives of controlling shareholders
- Representatives of other holders of significant blocks of shares
- Chairperson and members of the Board of Directors, including any “independent” Board members and the chairs of the audit, credit, risk management, asset and liability and other special committees of the Board (and where applicable, members of the Inspection Committee: the Fiscal Board, *Commissaire*, Audit Commission, *Comisario* or *Revisor Fiscal*)
- Chief Executive Officer
- Chief Financial Officer (or senior accounting officer)
- General Counsel (or senior lawyer)
- Corporate Secretary
- Chief of Internal Audit and Internal Controls
- Chief Compliance Officer
- Chief of Investor Relations
- Independent External Auditors