

***GUIDANCE FOR THE DIRECTORS OF  
BANKS AND OTHER FINANCIAL  
INSTITUTIONS***

***Jonathan Charkham CBE***

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## **INTRODUCTION**

This paper, for present and prospective directors of ‘non-complex’ banks, is intended to provide a guide to international best practice. It is designed to help boards of directors in a practical way attain and maintain a high standard of internal governance. A directorship of a complex bank, especially a large one, implies a further dimension; even so the basic considerations set out in this manual still apply.

This paper supplements a country’s laws, rules and other local guidance. Together their aim is to set banks and financial institutions on the path towards enduring prosperity. This is a matter of great importance to all - depositors, employees, customers, shareholders, the supervising authority, and the country.

Good governance is essential for long term survival and success, so directors have a continuing obligation to ensure that not only do they themselves understand and practice it, but that managers in their organization are properly trained in its principles and practical application.

This paper provides an overview. Directors in all countries are advised to familiarize themselves with the scope of the relevant legislation, noting that they may be personally liable for breaches of certain provisions. There will be in existence more detailed guidance on the subject matter of every section of this manual. The intention of the manual is to ensure that the underlying principles are not swamped by the detail and to give directors a fundamental understanding of their tasks and the context.

The good governance of any commercial enterprise depends greatly on the skills, experience and knowledge of its directors. Banks and other financial institutions require in addition that the directors keep abreast of relevant developments systemic, regulatory, technical and financial (including accounting). It is therefore essential that individual directors see this as a personal responsibility, and that the board ensures they receive the advice and training they need.

The guidance was drafted to fit unitary boards and it would need to be adapted to fit a two-tier system in which the management and supervisory functions are formally separated. Even then the underlying parcel of functions remains the same though their discharge is different.

Throughout the paper the male gender is used as a matter of linguistic convenience. It is understood of course that everything applies equally to women.

## **1 GLOSSARY OF TERMS**

### **1.1 THE FAMILY OF TERMS**

There is a family of terms in descending order from the general to the particular to describe the direction in which the directors and shareholders wish the bank to take. Together they describe the framework within which plans are laid and decisions taken about priorities for action for the short, medium and long terms.

#### **1.1.1 Aims**

Of these terms '*Aims*' are the broadest and most general. They are sometimes described as '*Purposes*'. Some banks now publish a '*Mission Statement*'. Whatever term is used the intention is to be explicit about the main purpose for which the bank exists. Aims are not quantified. How much detail to include is a matter of judgement.

#### **1.1.2 Strategy**

Strategy is the design of longer-term policies to pursue the bank's aims. These policies may relate to products and services, acquisitions versus organic growth, markets, and resources - especially capital and people. Strategy will reflect priorities in the deployment of the bank's limited resources. It defines where the organization wants to go to fulfil its purpose and achieve its aims.

#### **1.1.3 Business plans**

Business plans are the blueprints for action for all parts of the business (and at various levels) to map out the way its strategy is to be attained. Wherever possible they will include objectives, time constrained and quantified, although not necessarily in terms of money.

All business plans must be firm but flexible because all businesses face uncertainty and plans have to be adapted from time to time. The virtue of having them is to impart a clear sense of direction and to secure the commitment of those called upon to formulate and achieve them. Many will often link with the budgeting process (for example a bank could budget for a partial increase in its deposit base). Plans also help to define the linkages between various aspects of the business. In banks for instance there is an absolute need to link expansion with capital adequacy.

### **1.2 MANAGING DIRECTOR**

Various titles have been given to the person or persons in charge of the bank's executive management such as 'Chief General Manager', 'General Manager' 'Managing Director' (there may be more than one, with equal status.). Recently the term Chief Executive or Chief Executive Officer (CEO) has come into more common use, but only if power has been concentrated in single hands.

### **1.3 CHAIRMAN**

Strictly speaking, the chairman is chairman of the board, not of the company and has duties as chairman relating mainly to the board itself. If he is also CEO or managing director he has in effect dual responsibilities.

### **1.4 CORPORATE GOVERNANCE**

Corporate governance is the system by which banks are directed and controlled in pursuit of their aims; and by which they relate to their sources of capital.

### **1.5 RISK MANAGEMENT**

Risk management is the systematic process for identifying the risks the business faces; evaluating them according to the likelihood of their occurring and the damage that could ensue; deciding where to bear, avoid, control, or insure against them (or any combination of these four); allocating responsibility for dealing with them; ensuring that the process actually works; and for reporting material problems as quickly as possible to the right level.

### **1.6 FIDUCIARY PRINCIPLES**

Directors of the bank must always act in its interests even in the face of a competing obligation. They must act in good faith. It would be a breach of faith to be disloyal to it (for instance by imparting its confidential or secret information), or to put one's personal interests (or those of family or friends) before its interests.

Directors must not personally pocket profits that should have accrued to the bank.

Conflicts of interest can arise in many ways and directors should always be on their guard. When in doubt they **MUST** disclose the matter formally to colleagues. Failure to disclose a material conflict of interest normally leads to resignation. In many cases the circumstances will require their absence from deliberations in which they are 'conflicted'. One particular situation may arise and catch them unawares - where they hold directorships of more than one company within the banking group. They should be aware that their duty to more than one company might mean that they have different fiduciary responsibilities in their various roles.

These principles mean that there is no such thing as a 'representative' director, even when a particular group of shareholders have the right of appointment. Once appointed, a director is bound to act in the bank's interests, that is to say in the interest of all the shareholders. He may not report to his appointers matters that the board deems confidential without its permission. Directors owe their duty to the bank and are answerable to the shareholders for the way they discharge it.

## **1.7 CONNECTED PARTIES**

The issue of connected parties may be important in many contexts, especially the concentration of risk. It arises where parties with whom the bank is doing business are technically separate entities, but where:

- One party has direct or indirect control of the other party, or
- the parties are subject to common control from the same source, or
- one party has influence over the financial and operating policies of the other party to an extent that the other party might be inhibited from pursuing at all times its own separate interests, or
- the parties, in entering a transaction are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests.

## **1.8 RELATED PARTIES**

The context is different and mainly affects the terms and conditions on which business is conducted. The danger is that improper preferential treatment may lead to a weakening of normal disciplines in such matters as granting facilities, the terms, and the subsequent monitoring of accounts. Parties are 'related' if they are:

- Members of the bank's board of directors, its external auditors, advisers, a senior manager or one of his deputies and equivalent.
- Relatives of the above or where there is a vested interest between the two parties.
- Any natural person or entity that directly or indirectly owns a material percentage of the bank's voting shares and relatives of the natural person.
- Subsidiaries or other affiliates of the bank.
- Any entity in which the bank directly or indirectly owns a sufficient percentage of the shares to enable the bank to influence its operations.

## **1.9 LIQUIDITY**

Liquidity is the means by which a bank ensures that it can always pay what it owes on time, which is vital to confidence in it and so to survival. This is usually achieved by some combination of a well diversified asset base, holding readily marketable liquid assets, managing the maturity profile of assets and liabilities, and borrowing/lending in the inter-bank market.

## **1.10 CAPITAL ADEQUACY AND THE RISK-ASSET RATIO**

Capital adequacy is the amount of capital required by the regulator for the business the bank conducts or intends to conduct. It may take various forms especially a mix of equity, preference shares and subordinated loan capital. In practice the regulators will decide the banks minimum requirement. In approaching this decision they will

consider the risk profile of each function appropriately weighted for quality. Weightings are decided by the regulators and reflect international standards. The total of the weighted risk amounts is then compared with the bank's capital to calculate its 'Risk Asset Ratio'. This is the primary means by which the regulator and the board can monitor capital adequacy.

### **1.11 GLOBALIZATION**

Globalization has many dimensions. It may refer to:

- The increasing ease with which business may be conducted in any part of the world, due to improvements in information technology.
- The increasing tendency for financial institutions (or other business) to establish a presence in many countries to facilitate the conduct of business
- The gradual adoption of uniform standards around the world (for example in accounting and auditing).
- The growing possibility of obtaining employment in any part of the world for those possessed of the necessary skills (such as computer programming).
- The gradual adoption of one particular language as a convenient way of facilitating business globally.

### **1.12 INDEPENDENCE**

The legal systems under which most banks are structured tend not to distinguish in a formal sense between different classes of director; in law all have the same basic duties. It is generally the case that some directors have executive duties and may therefore be known as 'Executive directors'. Directors who have no such responsibilities are therefore known as 'Non-executive Directors' (or non-management directors, or in some cases as 'outside directors'). It is however often the case that a director without executive duties may have or have had some other connection with the company, for example:

- Having had executive duties in the company in recent years.
- Being a member of a firm that provides professional or other services or goods.
- Being connected to the managing director(s) or any senior director or officer by blood.

Such people may have an important contribution to make to the board and the company but they cannot be said to be 'Independent'.

Independence means their being independent of management - objective in their appraisal of situations and unfettered in the opinions they express.

Independence is an attitude of mind and an attribute of character. Apart from the three circumstances listed above it may be compromised if they are under any financial or moral obligation that might curtail their freedom of action; this may be the case if for

instance they regard their appointment as being an act of patronage by the Chairman or CEO to whom they therefore owe personal loyalty.

Independence means not yielding to threats or blandishment, but forming a view on the basis of the best available evidence and standing one's ground. Maintaining independence does not imply solitariness; concerns can be shared with independent colleagues. Independence means putting the bank first come what may.

## **2 CORPORATE GOVERNANCE**

The interest in the systematic way in which companies, including banks, are directed and controlled is relatively recent (arising over the previous 25 years). It was stimulated in the first place by concerns about fraud and later by the failure to correct evident managerial incompetence. Recently there has been more concern to facilitate investment and capital flows. All three aspects are united in a simple theme - if a company wishes to attract investment it needs to be able to show it is well and honestly run and that the information it produces is comprehensive and accurate. Viewed by potential investors, it would be unwise of them to risk their savings unless these conditions are satisfied.

Experience has shown that good governance requires sound structures and process, and that checks and balances are vital to ensure that power is not abused. This has implications for the role and composition of the board, the creation of committees of the board especially the audit committee, and the contribution that independent outsiders could make to the decision process and to monitoring.

The emphasis of corporate governance developments has throughout mainly been on control and monitoring - and rightly so given the failures, frauds, and flows of misinformation that stimulated the reforms in the first place and are still a matter of concern today. Good corporate governance will improve economic benefits and that this means vigorous enterprise as well as effective controls. Without enterprise a bank will go nowhere, however well it is controlled. The need for systems of control does not eliminate the need for enterprise - new products and services, new markets.

Opportunity and risk are two sides of the same coin, but seeing opportunities requires flair, often a sort of creative genius, whilst systematically keeping risk under control is a relatively mundane but essential part of the process. A real danger arises when an entrepreneurial genius has started a business successfully, has become convinced of his own ability and is irked by constraints. Long term success depends on a balance between enterprise and control and high standards of both.

The economic benefits of good governance affect a wide range of people - depositors, employees, creditors, shareholders and other investors, the community and the country itself.

Several themes are reflected in the manual, appropriate structures, appropriate process, integrity and transparency. Underlying them all is the general principle that continuing prosperity requires a systematic approach both to enterprise and control.

There is an identity of interest between bank directors and banking supervisors in respect to corporate governance. They both want it to be as sound as possible and to be effective and efficient. It follows that directors and supervisors should work closely together to achieve the best results. It is in that spirit that the following sections of guidance have been drafted.

### **3 THE FORMAL STRUCTURE OF THE COMPANY**

#### **3.1 THE LEGAL FORM**

There are various kinds of legal structure designed to facilitate the conduct of business, each with their own statute and set of laws and rules. These include partnerships and mutuals. None is a creature of nature so we must look to the law to determine the way they are to be governed. The basic form for banks is that of the Limited Liability Company (whether or not the shares of the Company are quoted and traded on a Stock Exchange).

The framework of the Limited Liability Company is designed to:

- *Facilitate the aggregation of capital*  
Companies are an effective way of mobilizing the savings of a far wider and more numerous section of the population than is convenient with other forms of enterprise. In the industrial sphere investors, that is to say shareholders, have the protection of limited liability and this is also generally the case with banks too.
- *Create the possibility of “corporate immortality”*  
Unlike partnerships and several other forms of organization a company does not dissolve when one of the partners dies or resigns. Companies can in principle survive indefinitely. There are examples in some countries of companies that are well over a century old
- *Provide for the concentration of the power to manage*  
For a bank or any kind of business to prosper there must be the power to manage the enterprise, and this must be concentrated enough to be effective. Such a concentration is especially necessary to deal with long-term projects, though this does not in any way preclude changes of manager when appropriate.

Banks are generally subject to special laws in addition to the basic law governing companies (in the UK, the Companies Act). Banks everywhere are supervised either by their central bank or a specifically empowered body such as the Financial Services Authority (FSA) in the UK. The reasons for this additional law and supervision is due to:

- Their importance at the centre of every country’s financial commercial and industrial framework.
- The nature of their business which means that they are highly geared.
- The wider effects of their demise which affects depositors as well as trade creditors and shareholders.

### **3.2 THE DIVISION OF COMPANY FUNCTIONS**

The role of the three parties in a Limited Liability Company can be described in general terms, with the directors in a pivotal position between shareholders and management.

The shareholders provide the equity capital. Their powers are important but limited. They alone can appoint and dismiss directors. Their agreement is required for certain types of transaction (specified either by the general law or by the company's by-laws), such as raising new capital, or major acquisitions and disposals.

The directors are entrusted by the shareholders with the running of the business. They owe their loyalty to the company and are accountable to the shareholders for their stewardship. Accountability implies transparency. .

Managers are appointed by and are answerable to the directors, and have authority delegated by them for running parts of the business. Directors may, and in the early stages of a business usually do, have managerial responsibilities too. When this is the case they need to be aware of their dual responsibilities. They are at the same time responsible for specific operations or functions and are also part of the collective decision making process of the board.

This formal division of functions may be obscured if the same person is simultaneously a major shareholder, a director and a manager. This produces a concentration of power with few checks and balances. This arrangement can work well, even spectacularly so for a period of time, but its weakness is that it may be difficult to deal with problems that arise when the leader falters because it is difficult to control him or bring in new blood. Corporate governance reforms have been designed to mitigate some of these effects but a dominant 'founding father' of a business is notoriously hard to keep in check. This is an area of especial interest to the Supervisors.

There is another dimension to accountability in respect of what are sometimes called 'stakeholders', people who have an interest in the bank's prosperity but do not necessarily hold shares in it. They include the depositors, customers, employees, suppliers, existing and potential shareholders and investors and local communities. The directors are not accountable to any of these groups but must take full account of their interests as the bank is most unlikely to succeed otherwise. To neglect any of them is to invite problems and difficulties. A concern for 'stakeholders' is a part of what has come to be called "Corporate Social Responsibility"

## **4 THE STRUCTURE AND COMPOSITION OF THE BOARD**

The board, as well as the company, needs a leader, and should elect one of its number to act as chairman (the appointment will generally need the approval of the regulator). It is his task to lead decisions on the composition of the board itself. His responsibilities always include the preparation for and conduct of board meetings. He will sometimes be the public face of the company in reporting on its progress. He may not have any other executive responsibilities and may therefore be part-time.

The chairman of the board may be CEO too or the roles may be divided. Except in small banks, dividing the roles is normally recommended, partly because the workload of doing both jobs is significant, partly because dividing the two improves the operation of checks and balances and lessens the likelihood of a concentration of power becoming dangerous.

Where there is a separate chairman, he and the CEO may decide together on the allocation of functions. The task of representing the company to investors may for instance be divided or left to the CEO, or indeed shared more broadly, typically with the finance director or the head of investor relations.

As noted above, the effective governance of the business requires the board to strike a balance at a high standard of effectiveness, between driving the business forward and controlling it prudently. This in turn requires a balance on the board between the executive and non-executive directors. This balance will be assisted if some and preferably a majority of the members of the board are independent (as defined). In the last resort any board should be able to challenge and stop its CEO (or managing director(s)).

‘Independence’ is defined in the Glossary above. Independent directors must be people of character and relevant experience. They will often have a valuable constructive contribution to make both on and off the board because of their knowledge and contacts.

If any institution does not appoint independent directors, it is all the more important that all the executive directors exhibit the qualities of independence - not always easy as the chief executive is their superior. This is another reason why the chief executive should not be chairman too - it leads to an overwhelming concentration of power which it is tempting to abuse.

Boards should be no larger than strictly necessary for the conduct of business, even when they include appointees from large shareholders. The larger boards get, the more likely it will be in practice for serious decisions to be decided by an inner committee beforehand.

An ideal board will include members with a wide range of different backgrounds and some perhaps with special financial, technical, or marketing skills, others perhaps with a breadth of other experience. Recent U.S. legislation requires a member of the audit committee and therefore of the board to have a high degree of financial literacy.

If the bank is trading in complex derivatives, the minimum standard required should be that one member of the board at least should be sufficiently knowledgeable to understand and question them. The general objective of having various skills is not to substitute their experience for expert advice, which the board will need in particular situations, but to ensure that matters are appropriately considered. The regulator's approval is generally required on every appointment to the board and it will take into consideration its balance and composition.

Assessing how well the board works and the contribution, both on and off the board, of its individual members is delicate and difficult but it needs to be done. One of the reasons for giving directors a specified term, which should be the rule, is that reappointment provides a convenient occasion for such assessment. This does not preclude re-appointment by common consent, but all boards need periodically to refresh the membership and make changes.

## **5 RESPONSIBILITIES OF THE BOARDS OF DIRECTORS OF BANKS**

### **5.1 GENERAL**

Banks are different from the generality of companies in that their collapse affects a far wider circle of people and moreover may undermine the financial system itself, with dire effects for the whole economy. This places a special responsibility upon a bank's directors. This responsibility remains with them even though they operate under the supervision of a regulatory authority whose task is to ensure their business is conducted in a way that is conducive to stability. Their regulators' concern will be with the quality of the bank's management, starting with the board of directors itself.

As directors cannot do everything themselves and must delegate, they must constantly keep in their minds the capacity of those to whom they entrust authority and the framework for checking its sound, sensible, and honest use. Unless they do this they cannot claim that they have discharged their responsibilities. Each director individually and the board collectively should consider themselves responsible for the effective and efficient management of the bank.

They will need to meet as a board as often as the conduct of business requires but never less than quarterly. It is the Chairman's task, supported by the Company Secretary to ensure that an agenda with the relevant supporting papers be circulated to all members at least seven days beforehand. The Chairman must ensure that the order of the agenda and the conduct of meetings do justice to the importance of the issues before the board. Minutes of the meeting's conclusions should be circulated in draft within seven days afterwards. They should record the principal arguments but not normally attribute them to individuals. Individuals who dissent from a decision the board has reached may require the Secretary to record the fact in the minutes. The minutes should state where the responsibility lies for executing agreed decisions.

The board must timetable all its meetings in advance for the coming year including a timetable for reporting from all the relevant committees and the internal and external auditors.

In countries with unitary boards some directors will have two sets of duties, those duties that flow from their position as directors and their executive duties. Whether they are 'non-executive' or 'executive' directors the main elements of their work are described below.

### **5.2 ENTERPRISE**

The main elements of the directors' duties relating the overall enterprise of the bank are:

- To support management in its task of driving the bank forward and, to that end to encourage innovation.

- To consider with great care the bank's human, physical and financial resources and its strength and weaknesses. Therefore to agree, against this background, its aims, long-term strategy, and its medium and short-term business plans, bearing in mind at the same time the external economic environment in which the bank will be operating.
- To make sure that plans are communicated throughout the organization to those who will be affected by them.
- To institute and support a clear framework of policies and objectives in all spheres within which management must operate. These would cover personnel policies, the basic financial regime including budgeting, and financial operations including asset and liability management, capital planning and investments.
- To deal with mergers and acquisitions.

### **5.3 LEADERSHIP**

With regard to leadership the director's duties are:

- To set the tone for the behaviour of all the bank's employees by example and precept. Integrity is indivisible. Statements about the bank's corporate values and ethical policy should be short, simple and made available to everyone; but it is the example of the directors themselves that constitutes the most persuasive statement about ethics.
- To disclose any possible conflicts of interest in matters before the board and abstain from participating in the discussions on it and refrain from voting (which should be minuted).
- To ensure that the bank's operations conform to all applicable laws.
- To encourage the confidence of depositors and clients in the integrity of the flow of information from the bank. Directors must recognize the dictates of commercial confidentiality, but never use this as an excuse for unnecessary opacity. They should consider transparency to be the norm; the burden of proof rests with those who would wish to limit it to show that commercial necessity has to be paramount.
- To solve the problems posed by related party transactions. A well run bank will have developed systems for assessing and monitoring loans and for addressing the element of risk in any kind of transaction. It will have devoted resources to promulgating rules and to training staff on how to apply and monitor them. It is confusing to the staff if they are put under pressure to relax the rules on the grounds that a particular party is privileged perhaps through consanguinity or because of an outstanding obligation. Such relaxation may mean participating in a transaction they would otherwise have declined; or doing so on unusually favourable terms; or allowing situations to develop that should have been faced sooner (like calling in a loan that has become dubious). The board should decree that a credit assessment should always be conducted on the 'arm's length' principle and never be affected by such considerations, and no course of action that would normally be considered inappropriate should be pursued - including

settling old scores by inappropriate harshness. Related party transactions should be listed in the annual report.

The distortions caused by related party obligations extend far wider than loans and include contracts and employment. The board needs to make sure that the bank is not being injured thereby.

## **5.4 REPORTING**

Although increasing responsibility now rests with audit committees (see below) for vetting financial statements and discussing them with the auditors, the ultimate duty to ensure that any reports issued by the bank, including the financial statements, present a 'true and fair' view of its position and performance still rests with the board as a whole. Whatever advice they receive and whatever the formal requirements it is not acceptable either by statements or omissions to knowingly present a misleading picture.

## **5.5 COMMUNICATION**

Directors should ensure that there is an agreed communications strategy and procedure including agreement about appropriate channels and spokesmen. This includes a decision on what part, if any, independent directors may play. It is too late to start considering such matters when a crisis strikes.

## **5.6 CONTROLS**

In relation to controls and the control environment director's duties are:

- To ensure that the board receives periodical reports about the financial position of the bank and its performance in the form (including the degree of detail) and at intervals most appropriate to its business.
- To monitor progress towards the bank's objectives (this will often be set in the context of performance against budgets).
- To ensure that its operations are properly controlled and to this end to set and enforce clear lines of accountability and responsibility throughout for identifying, managing, and reporting on risk (see below).
- To ensure that there are sound systems for decision making and control and that the systems are effective by having them regularly tested and reported upon.
- To ensure that the managerial responsibility for each system is in sound hands and that managers know the risks they 'own'.
- To ensure there is an effective internal audit arm with a direct reporting line to the CEO and the right of access at all times to the chairman of the audit committee.
- To receive reports from the auditors, management, and the audit committee on material breaches of laws, rules, and supervisory regulation (including instructions from the regulatory authority which may come in the form of formal or informal administrative action) and ensure that management takes the necessary action (see also the Audit Committee below).

- To ensure that managers address all security related matters and receive expert advice on the design, planning, and implementation of security standards, procedures, and systems covering all aspects of physical and technical security aimed at safeguarding the assets and operations of the bank. Breaches should be reported and serious incidents or shortcomings should be brought to the attention of the board.
- To establish clear written policies in regard to Treasury operations and receive reports regularly on them together with any breaches of these policies.
- To establish clear written rules on investments and require regular reports in respect of them.
- To ensure that written rules are promulgated to prevent fraud and deal with it if it is suspected or discovered. Frauds and suspected frauds should be reported at once, and in any case management should be required to report any incidents at six monthly intervals (fraud is covered in more detail in Annex 2).
- To satisfy themselves that the bank's arrangements for detecting and reporting money laundering conform to official advice and instruction. This may require the board to appoint an official with responsibility for a regime against money laundering (In the UK this means appointing a Money Laundering Reporting Officer in accordance with the FSA's instructions. The FSA's approval is required to the appointment). In larger banks the official will need the support of a special Money Laundering control unit. In all cases the board should ensure that staff receive a manual to tell them what is required of them. The board should consider carefully how to encourage staff at all levels to be alert to suspicious transactions - as well as making it known that 'turning a blind eye' will not be tolerated. An effective operation against money laundering will help safeguard the bank's reputation and assist the authorities in their struggle against organized crime. A general background note on money laundering is in Annex 3.
- To ensure those operations abroad have a well-considered remit and are carefully monitored and controlled. Directors will bear in mind that operations overseas, especially in the main financial centres are fiercely competitive, and that this imposes exceptional strains on the bank's officials in the form of the quality of local staff they are able to recruit and the risks they are assuming in their efforts to build up the business.

## **5.7 HUMAN RESOURCES**

- To select competent executive officers and dispense with the services of the inadequate.
- To promulgate policies designed to maintain the quality of management by sound appointments. It is vital that at all levels management should know their staff and have ascertained that they are fit and proper for the work on which they will be engaged. Their competence and honesty should be above suspicion.
- To establish programmes for training and retraining at all levels including board members themselves. Independent directors should have a course of induction on appointment to familiarize them with the company's operations. All directors on

first appointment should be taken through this guidance to familiarize them with the functions of the board and its committees.

- Where necessary to transfer or remove the inadequate. Poor leadership infects. The appointment or dismissal of the CEO is in practice the single most important function of the board.
- To develop a policy for staffing internal audit. It should NOT be regarded as a place to dump people who are unsuitable for line management. Internal audit needs high quality staff. One possibility is to make it general practice that the liveliest shall serve there for a spell from time to time in the course of their careers.
- To ensure that the system of remuneration in the bank is satisfactory.
- To protect members of the board by insuring them against personal liability (see Annex 4).

## **5.8 FINANCIAL AND OTHER PHYSICAL RESOURCES**

Directors' duties with regard to resources are:

- To monitor liquidity and the financial position regularly (normally monthly).
- To monitor the adequacy of the bank's capital. Directors will understand that the bank's capital protects its depositors against possible losses. They must decide the form and quantum in the light of the types of business it proposes to solicit and conduct and the risk attaching to each. They will be aware of the need to make the best use of capital in order to provide investors with a satisfactory return and at the same time not to underestimate the credit, market and operational risks that attach in varying degrees to particular types of business. Regulatory supervisors weight the risks to reflect the qualitative factors (in the light of international standards) and compare the weighted risk with the bank's capital to calculate its 'Risk Asset Ratio'. This is the primary means by which the regulatory authority and directors can monitor capital adequacy.
- To make sure, through the risk management committee or its equivalent, that management has put in place the necessary insurance policies, using professional insurance advisers, and to receive an annual report on the insurance coverage and the quality of the insurance companies with which the business is placed.

## **5.9 STRUCTURE OF THE COMPANY**

Directors should decide on the operational structure of the company in the light of the proposals made by executive management.

Proposals for reorganizations and restructuring should be examined with care as they are always costly and disruptive. The board should review such proposals carefully to ensure that the benefits suggested are worth the additional strain they impose.

A change of control or management often brings with it proposals for structural change, sometimes on the grounds that the re-organization will achieve savings. The board should take the greatest care to ensure that projected economies and savings are

realistic and are in fact obtained. Mergers affect people who will naturally fight to defend their own position. Obtaining so called ‘synergies’ is generally far more difficult than projected, and puts great pressure on managers and responsibility on the board.

#### **5.10 THE AUDIT COMMITTEE**

- To establish an audit committee with terms of reference recorded in a formal board minute and to select the members of the audit committee from the independent directors. Besides the personal qualities of judgment and character, members should be chosen for their experience and acumen and their capacity to handle the reports they will receive about risk and the operation of the bank’s various systems. As noted above at least one member of the audit committee should have a sufficiently sophisticated knowledge of financial matters to deal with the more abstruse instruments in which the bank trades.
- To institute a process of induction for new members of the committee in relation to their duties and encourage them to familiarize themselves with the operations of the company at home and abroad
- To refresh its membership as needed to maintain its skills and commitment
- To approach the selection of the chairman of the audit committee with especial concern about his strength of character and independence from the executive and management. Potential conflicts of interest should be avoided and this rules out the chairman of the board serving as chairman of the audit committee even if he is not the CEO.
- To empower it formally so that is well equipped to execute its functions. The board should give it the right to:
  - (a) Have direct access, without management present, to the head of internal audit, to the senior partner of the accounting firm conducting the audit, and where necessary to the partner of the firm of actuaries advising the bank
  - (b) Have access to any employee
  - (c) Conduct such investigations, as it thinks fit.
  - (d) Obtain such professional advice, as it thinks necessary at the bank’s expense.
- To monitor the functioning of the committee and approve, at regular intervals a statement of its programme for discharging the responsibilities the board has laid upon it; this will include a report on the frequency of its meetings, and its relationship with external and internal auditors supervisors and examiners.
- To commission and receive reports about the re-appointment and remuneration of the external auditors and submit their conclusions to the Annual General Meeting. The Chairman of the Committee should be in attendance to respond to questions.

#### **5.11 CREDIT FACILITIES**

Various structures and processes are used for granting and monitoring facilities; some banks operate on hierarchical lines with clearly specified limits of authority at

different levels. Others rely more on committees. In many cases, especially in large banks operating internationally there may be some form of matrix controls and procedures in which both product and region figure. Whatever the choice, it is the board's task to establish the policies within which loans are granted and monitored, and to make sure that the bank has the appropriate structures, procedures and lines of reporting, and clear definition of responsibilities. Nothing must fall between the cracks. Such policies should address among other matters, any geographic or sectoral issues, (such as personal mortgages, agriculture, and commercial real estate), and maturity.

Officers and managers (and committees) that consider applications for loans, letters of credit and acceptances should be instructed to report on an applicant's total liability to the bank. The board needs to decide how best the loan review process is reported to it and to what degree of detail.

In addition to the above the directors duties are:

- To ensure that appropriate officials or committees receive reports monthly on new credit facilities (other than small ones), and also full particulars of those that are overdue or in default (together with details of the proposed recovery action).
- To ensure that all credit facilities are monitored annually at the appropriate level.
- To consider liabilities in aggregate and their funding.
- To sanction the writing off of material non-performing debts. The board will have decided beforehand the limits of delegated powers and how it defines 'material'. The board should recognize that officers are naturally reluctant to admit that credit facilities they have sanctioned are going wrong, and should encourage them to overcome their reluctance to report incipient problems.
- To establish in writing a provisioning policy. The board should be cautious and conservative in making provisions for facilities where the risk of loss is high and should be prompt in writing them off if they prove irrecoverable.
- To ensure that the valuation and classification of assets is appropriate and that there are proper reporting arrangements to the board on material issues.

## **5.12 RISK MANAGEMENT**

The operation of a bank or financial institution inevitably means facing risks of many kinds. The board will know that handling risks of any kind should start with a systematic analysis of the two elements of materiality, probability and impact. Probability is the likelihood of the event occurring and impact is the damage that might be caused if it did.

The board's task is:

- To deal with strategic risk. Such risks affect a bank's basic policies and cannot be delegated, even to the audit committee. They need to be considered systematically. For example, is the bank in the right markets? Are its products and services appropriate and competitive? What threats are posed by competitors?

What weaknesses must we address? (Sometimes called SWOT analysis - Strengths, Weaknesses, Opportunities, and Threats.)

- To ensure there is an adequate system for handling all other kinds of risk, that each is 'owned' by specific managers or committees that the systems work and are objectively tested. The board should receive regular reports affirming their effectiveness and any material failures together with details of how the matter is dealt with. The board will recognise that some risk always remains a residual risk, which management must identify and accept.
- To establish the structures and processes for granting and monitoring credit facilities and to monitor and to consider applications that cannot be dealt with under delegated authority.

### **5.13 COMPLIANCE**

The volume and complexity of legislation and regulation that now applies to companies in general and banks in particular are so great that no director could reasonably be expected to master all the details. Nevertheless all directors should:

- Know what the scope of the main laws and regulations is;
- ascertain where within the company expertise lies;
- know how compliance with the law is assured; and
- receive reliable reports on compliance and any material failings.

Some provisions are so important that a wise bank director will familiarize himself with them.

If the bank is quoted on a stock exchange directors should be aware of the obligations that flow therefrom, in Stock Exchange Listing rules, Codes of Corporate Governance and so forth.

### **5.14 SOCIAL RESPONSIBILITY**

Directors should ensure that the bank follows policies that are socially responsible in all relevant areas including care for the environment.

## **6 COMMITTEES OF THE BOARD**

### **6.1 INTRODUCTION**

Running any kind of financial institution requires carefully planned executed and monitored systems at every point. These are essential to ensure that funds in the business are deployed sensibly, do not go astray, and can be traced after transactions have occurred. Risks are unavoidable, but need to be considered systematically.

A systematic approach engages everyone in the business, as it covers all activities. It is no use having systems unless everyone works within them and is committed to do so. This means that they must be well-designed and as simple as possible whilst being effective. They must be clearly understood by those who have to operate them. This will mean training, as systems tend to become more sophisticated technically. They must be tested and here the internal and external auditors have their part to play. They must be periodically reviewed to see how they can be improved.

In practice boards establish committees to help them ensure that the bank is being soundly managed; most banks have an Executive committee as well as an Audit committee (which is mandatory). These and the other main ones are discussed in detail below. It is however crucially important for the Board to ensure that committees should facilitate the conduct of business and do not unnecessarily impede it, by, for instance, duplicating the work to be done or getting lines of communication crossed. In banks the speed of reporting and decision making is often crucial.

All committees derive their powers from what the board wishes to assign to them; the board may delegate but can never abdicate responsibility. It is for the board to establish the terms of reference in every case and ensure they are appropriate. It is also for the Board to name the Chairmen and members, and to arrange how the committees should report. It is for the Board to monitor the committee's effectiveness.

The Chairman of the bank should keep the regulatory authority informed of the existence of committees of the Board together with their terms of reference and membership. The names of committee chairmen and members should be listed in the annual report.

### **6.2 THE EXECUTIVE COMMITTEE**

It is common practice, but not mandatory, for banks to appoint an executive committee comprising senior line and staff managers with the CEO (or managing director) as chairman. This is a convenient way to separate the task of running the institution on a day to day basis from the consideration of longer-term strategic matters. It is for the Board to decide its terms of reference and lay out the matters that should be reported to it for information or decision. Many of the matters of which it disposes will not be material enough to warrant the attention of the board. There are, however, many matters which are on the borderline and it is a matter of judgment as to which need reporting. There will be an overlap between the membership of the

Board and that of the executive committee. It is common practice for the Finance Director to be a member of both, and for that matter any member of the board with significant executive responsibilities.

This committee will meet far more often than the board- at least monthly and perhaps fortnightly or weekly. It can be summoned at short notice to deal with any significant issue.

It is common practice for the Chief Executive to report to the board on any major issues that have arisen; in most cases he will have ensured by prior discussion with the Chairman of the Board which items should appear on the Board's agenda.

The executive committee is a convenient body to deal with specialized subjects which are not the province of any other committee, for instance Human Resources, Information Technology, Insurance, or Environmental matters. Whether any of these subjects deserves a separate committee of its own is a matter of convenience depending on the length of the agenda and significance of the subject.

The Executive Committee can also serve usefully as a forum in which ideas and problems can be discussed informally.

### **6.3 THE AUDIT COMMITTEE**

#### **6.3.1 Background**

Appointing an audit committee is sound practice and many consider it indispensable. Most regulators require banks to do so.

The key features of a good audit committee are its thoroughness and its independence. It will not for instance allow itself to be pushed around on the accounting treatment of results or by obscuring issues raised by related party transactions.

Audit committees play a key role in financial control and reporting, thus strengthening corporate governance and increasing public confidence. In helping to protect the bank's assets they are serving the interests of shareholders, investors, depositors, regulators, and all who work in and have dealings with the bank. They are allies of the banking supervisors and should work closely with them.

#### **6.3.2 Composition**

The audit committee of 3 to 5 members will be appointed by the board and should be formed exclusively of members who are independent of management. The members of the committee will have been considered and approved by the regulatory authority on first appointment to the board. The maximum period for an initial appointment should be three years. It may be renewed periodically with the agreement of the parties and of the regulator.

#### **6.3.3 The Chairman**

The board will appoint the chairman of the audit committee. He sets the committee's style, tone and agenda; its effectiveness rests heavily on him. It is therefore crucial that he be independent as defined above. He will find the task is increasingly time consuming as it necessitates meetings with the internal and external auditors as well as the finance director (or Chief Financial Officer) if the job is to be done thoroughly.

#### 6.3.4 Remuneration

The remuneration paid to the chairman and members of the audit committee should be published in the annual report.

#### 6.3.5 Meetings

The committee should meet as often as the dispatch of business requires. Three or four meetings in a year would be usual (plus any additional meetings with the external auditors felt to be necessary). The chairman will so arrange meetings that at least twice a year the committee can meet the external auditors without management being present; and with management without the external auditors being present. Ideally the decisions the committee reaches will be unanimous. If there is a vote and it is deadlocked the Chairman's view shall prevail.

Members of the bank's management including the general manager or CEO (and any employee) may be invited to attend. The finance director will also normally be invited too. The internal and external auditors will normally be invited to attend.

The minutes of the proceedings of the audit committee will be circulated to all members of the board and the chairman of the board as soon as possible and placed on the agenda of the next meeting of the board when the chairman of the audit committee will draw the board's attention any material issues in the minutes or that have arisen subsequently.

#### 6.3.6 Relationships with the Regulators

The audit committee should see itself as an ally of the regulators; they share a concern for sound controls and accurate information. It follows that there should be close co-operation and openness. This implies liaison with the regulator and, where required, any appropriate foreign regulatory authority. If the regulator issues instructions or makes recommendations the committee must get reports from the bank's managers that they have been put into effect.

The Chairman of the audit committee may be required to meet representatives of the regulator with executive colleagues (and in exceptional circumstance, alone). He should of course co-operate but resist pressures so to extend the scope of his office that it impinges on the domain of executive management.

#### 6.3.7 Functions

The four major functions of the audit committee are described below:

- *Financial Reporting*  
To improve the quality of financial reporting by reviewing the financial statements before the board considers them, focusing particularly on changes in accounting practices, significant adjustments resulting from the audit, and compliance with accounting standards. Whatever the formal requirements, the committee must satisfy itself that what is being presented produces a true and fair picture of the company's position and performance (the effective conduct this task will help to raise the standards of and confidence in financial reporting and

auditing). Part of this task, for which they will look to internal audit, will be to ensure that income has not been over accrued, that expenses have been accrued and not hidden or capitalized and that 'off balance sheet' transactions do not actually or potentially have a material effect on the situation.

- *Controls*

- (a) To appraise, improve, and reinforce the control environment. As part of this, it will review the statement on corporate governance and internal controls in the ensuing annual report. This includes the design, operation, manning, and testing of the system of control, thus enhancing a climate of discipline and control and reducing the opportunity for fraud. In the course of this function it will have reviewed the relevant management reports and the information required by the regulatory agencies.
- (b) To review the bank's system of risk analysis and controls and ensure they work and are cost effective.
- (c) To require management confirmation that they have introduced and maintained a sound financial reporting system and to obtain assurance from the auditors that it does in practice generate accurate, reliable, and timely information.

- *The internal and external auditors*

- (a) To improve communication with internal and external auditors so as to enhance their independence. This is achieved by meeting the auditors regularly to check on their relationship with management, to discuss any emerging issues, to assure themselves of the auditors' continued objectivity and independence; and to review and agree their audit plans for the ensuing year and the execution of these plans. One of the most valuable functions of the committee is to improve communication with auditors and enhance their status. The Chairman of the committee should provide both the external and internal auditors with direct access to himself any time they request it. He should meet the partner of the external auditors, who is in charge of the audit, once a year one to one.
- (b) To review periodically the remuneration and performance of the external auditors and ensuring they maintain their objectivity by agreeing a change of senior audit partner every 5-7 years. The Audit Committee should propose to the board when they deem it wise that a replacement firm be sought. In inviting tenders, the committee will set out the type, scope, and plan of the audit required. In making its selection the committee will assess the ability of the particular partner(s) a firm proposes to put in charge. The committee faces a dilemma when contemplating change. It knows that a new firm will take time to get to know the bank as well as the present auditors; that a whole new series of relationships will have to emerge and that there is much work and some cost in the process of change. At the same time auditors can get too close, or they can 'run out of steam'.
- (c) To ensure that the external auditors' independence is not compromised, and is not in danger of being compromised, by their fees from the audit becoming secondary to those they derive from other services such as consultancy. It may

make sense for them to render services that link closely with the audit for instance in tax matters, but the committee should encourage and if necessary require management to use other firms on other project work, in connection with a takeover and consultancy. This also gives the committee a chance to get to know of other firms and assess their competence.

- (d) To play its part in promoting the efficacy of internal audit and support it. It shall have the right to approve appointments to that department (the committee will find itself relying heavily on internal audit in the whole area of systems and controls. It will form a view whether its resources are adequate and its staff good enough. It may be assisted in its views by advice from the external auditors with whom the internal auditors should have co-operated.).
  - (e) To receive on behalf of the board relevant extracts from internal audits reports and draw to the attention of the CEO and the board any material matters in them. The Chairman of the committee should receive all the reports but only extract from them for the committee itself the relatively few items he judges significant or material. It is imperative not to swamp the committee with paper.
  - (f) To seek advice on the latest developments internationally in accounting and auditing and where material report these to the board. With the impending changes it is imperative that members of the committee understand them in principle and how they will affect the bank's stated earnings. If necessary members should seek advice in separate session from a firm of external auditors
- *Adherence to laws, regulations, and guidance*
    - (a) To review the external auditors management letter and management's response.
    - (b) To review compliance with the rules and observations of the regulatory agencies, monitor the bank's response, and report material deficiencies to the board. It is for consideration how to organize the compliance function. The board may decide it necessary to appoint a separate compliance officer, however, the essential features are that the responsibilities for compliance are clearly allocated and there is an adequate system for ensuring it works satisfactorily.
    - (c) To receive periodical reports, take the necessary action, and where appropriate report to the board (at least annually) on matters relating to the integrity of the bank, including breaches of rules and regulations on the laundering of money generated by crime or drug- related activity (see below), insider trading, related party transactions, litigation, significant violation of the bank's moral and ethical policies and its corporate code of conduct.
    - (d) Members of the audit committee, other directors, and managers must recognize that the responsibilities resting upon the committee are numerous and heavy. It is all the more important that the committee does not assume responsibilities properly discharged by the whole board and become a quasi supervisory board. It must not usurp the board's functions for instance the control of business risk.

- (e) The committee may, as a result of various events, have observations on particular people and should make these known to those responsible but they must remember that the responsibility for the competence of management rests with line managers and ultimately with the CEO.
- (f) The audit committee should not drown in paper or detail. Their business is materiality not minutiae. It is only too easy for others to evade responsibility by dumping it on the audit committee; they should not try to do so, and the audit committee should not let them.

#### **6.4 THE REMUNERATION COMMITTEE**

Directors' remuneration is a matter of concern to all who have an interest in the bank and to the media. Therefore it is essential that there should be openness about the total sums directors receive and the basis in which they are calculated (broken down into all the relevant elements such as basic pay, bonuses, incentive plans, share options).

There is a potential conflict of interest for directors who decide their own remuneration. It may help resolve this if the board appoints a remuneration committee composed mainly of independent members to make recommendations to it about the remuneration of members of the board. It is best if executive directors' remuneration is considered against a background of the bank's remuneration policy for its entire senior staff and its broader personnel policies. The committee should examine closely the way incentive and bonus schemes are calculated; and they should test the figures. They will also wish to examine with care compensation arrangement for loss of office, especially where poor performance causes it.

#### **6.5 THE NOMINATION COMMITTEE**

From time to time the board will wish to appoint new independent members, or independent members of the audit and remuneration committees. It will help to ensure a thorough and objective process of selection if a recommendation be made to the board by a properly constituted nomination committee itself including independent members. Names proposed by the committee and approved by the board will be cleared with the regulator in the usual way. The chairman of the board (whether or not he is also CEO) may chair this committee.

The best procedure is for an objective and methodical process to be followed:

- The decision about recruitment.
- The formulation of a 'job description', answering questions such as what kind of person should we seek to recruit.
- A formal or informal search (or both). This will include considering candidates already known to members of the committee and the board.
- The creation of a short list of suitable candidates.
- Taking references.
- Interviews with members of the board.

## 6.6 THE RISK MANAGEMENT COMMITTEE

This is sometimes called the Asset and Liability Management Committee. The board may appoint one or more committees to deal with risk management other than the management of strategic risk (as defined above) for which it has direct responsibility. The terms of reference of these committees will be to establish the structures and procedures for dealing with all other classes of risk.

Other than strategic risk there are two other main types of risk:

- Transactional risks; and
- Process risks (sometimes called operational risks)

Transactional risks are described below and Process risks are dealt with in Annex 1.

### 6.7.1 Transactional risks

It will be the committee's task, bearing in mind the range of business the bank wishes to undertake to institute the necessary rules and procedures to cover market risk and credit risk.

### 6.7.2 Market Risk

The first part of the committee's work - which will be important but in many banks relatively infrequent - will be to focus on risks associated with the particular types of financial instrument in which the bank trades like foreign exchange (forex), swaps and Treasury dealings generally. The characteristics of each of these instruments are their capacity to provide good profits or if not properly controlled to produce huge losses and even total ruin. It can and should aggregate counterparty's risks if it conducts various forms of business.

The committee's task is to get to grips with the proposed type of business in a particular market to control risk. It should sanction entry to the market (or not), laying down from the beginning what the limits are and establishing the rules about reporting. The committee is in a position to aggregate the limits granted to particular managers or departments and so to build up a picture of what the bank's total exposures are, thus enabling it to prevent the bank becoming over-extended.

Derivatives of great complexity are now on the market. Some are so complex and sophisticated that they are difficult to understand and the risks difficult to calculate (there are cases where a failure to understand and measure the risk involved have cost even large banks considerable sums). The committee should not permit managers to undertake any transaction unless they understand it fully, can measure its consequences and account for it properly. If they do so and problems emerge they should report them as soon as they have become apparent.

Adequate control of dealers is vital. They should know with absolute clarity what the limits are. From time to time dealers inevitably make losses. The committee should let it be known that timely reports of losses will not carry punishment. Cases show that it is seldom a first loss that causes serious problems, but the subsequent efforts

(often concealed) of traders to rectify the position by trading out of it. Management therefore needs to encourage dealers to own up to errors and report breaches of limits as soon as possible. Those who exceed limits - even when they make profits in doing so - should be discouraged. Persistent breaches should be a dismissable offence.

The committee should also recognise that there should be effective booking systems and that they operate satisfactorily even for complex trades.

### 6.7.3 Credit risk

By far the major part of the committee's work will be concerned with the bank's every-day business of granting and monitoring credit facilities. The board will have established the delegated limits and will have approved the framework for processing applications for loans and monitoring them when made.

The committee will:

- Ensure, through management and internal audit, that the system is working satisfactorily; that the board's procedures for granting or extending loans and ascertaining borrowers' creditworthiness have been observed; that discretionary powers at various levels have not been exceeded; and that the officers and managers responsible for loans collect and maintain credit information on borrowers. As part of their work the committee will wish to make sure that application for loans are routinely made (at the appropriate level), accompanied by the most recent financial statements and the previous one plus:
  - (a) A statement of assets and income to ensure the loan can be serviced.
  - (b) An assessment of the capacity to repay the loan when due.
  - (c) The stated purpose of the loan.
- Obtain periodical reports of credit facilities exceeding the stipulated limits.
- Review all large loans and letters of credit in detail and where necessary recommend approval or rejection to the board or the executive committee.
- Ensure that the bank's directors and officials seek approval for guarantees (or letters of comfort) as if they were credit facilities and periodically require those concerned to confirm that the circumstances of parties to whom guarantees (or letters of comfort) have been given have not materially changed. This is of vital importance as guarantees do not appear on the face of the accounts and the bank may be severely injured by unexpected defaults.
- Ensure that no individual credit facility exceeds the legal/regulatory limits. Exposure to connected parties must be aggregated and treated as one exposure, whatever the nature of the connection. They must also ensure that they are not being misled by customers using the device known as 'split limits' - in effect disaggregating borrowings so that each separate deal is within limits, but together exceed them.

In the course of its operations the committee will want to stress the importance of personal responsibility. Officials should be encouraged not to evade responsibility by

passing matters upwards unnecessarily. It is only too easy to hide behind a committee or someone else's judgment. If officials need sanction from higher authority they should always state their own conclusions - and not mind being over-ruled.

They must also face up to failures. No one likes to admit that a loan is going sour, but if it is the sooner this is reported the better. Concealment only makes matters worse. This is especially difficult with related party transactions, but these like others are better faced sooner than later.

It is not for audit committees to double-guess this committee on an individual decision, but it will wish to have reports on cases where the system has failed, for example. rules or limits were improperly disregarded.

### **6.7 'SPECIAL' COMMITTEES**

Board committees exist to facilitate the thorough and expeditious conduct of business. Circumstances may suggest that some subjects could best be tackled by a committee which included people not on the board, for instances executives or outsiders. Such committees need specific terms of reference from the board which cover their composition, functions, powers (including the right to commission research etc) and reporting.

## ANNEX 1 - OPERATIONAL RISKS

It is natural for officials at every level to consider business risk, as it is part and parcel of their every day work. It is much easier to forget that there are hidden risks in the sheer process of doing business of any kind, like fire, IT failure, or fraud.

All these types of risk are asymmetrical - none can produce a profit and it is a matter of avoiding loss. They are inevitable for all banks.

Smaller banks may handle this subject in the Executive Committee. Larger institutions tend to establish a separate Operational Risk Committee. In either case the role of the committee dealing with operational risk is to ensure:

- That as part of an operational risk management programme managers identify the principal operational risks and take the necessary steps - which may be acceptance, avoidance, control, or insurance or some combination of these. In the case of *Professional liability and lender liability* for instance, insurance will have a part to play and the committee should ensure that the necessary policies have been taken out. (see Annex 4) In the case of fire or the failure of an IT system, there must be sound business resumption plans to cope with a disaster. The staff must know what the plans are and the part they have to play. The committee must ensure these plans are tested.
- That the bank's systems address the financial and reputational risks of money going astray or being tainted or being misapplied. *Into this category fall fraud: electronic crime; money laundering; improper or unsound or concealed related party transactions; breaches of rules about the concentration of lending (perhaps by ignoring the "connected party" rules).*

The committee will have a central role in safeguarding the bank's future. It will aim to ensure that considering risk and controlling it are seen by managers as an essential part of their task, but they do not become an obsession at the expense of how best to drive the business forward safely and honorably. Furthermore, over complex procedures tend to be self-defeating, as formal compliance may mask concealed dangers. The aim in dealing with risks of all kinds is to get managers at all levels to factor them into the way they approach business and take the sensible steps required.

## **ANNEX 2 - FRAUD**

### **General**

The nature of the banking business makes it particularly susceptible to fraud. An international survey in 1993 by KPMG found that 80% were committed by employees, mainly the misappropriation of cash (and travellers' cheques). Size does not protect; on the contrary, the bigger the bank, the greater the risk.

Insiders (employees), outsiders, or a combination of both may perpetrate fraud. This kind of fraud requires a criminal conspiracy and may be especially damaging. Directors should bear in mind the need for perpetual vigilance and intelligent observation at all levels, for these are the essential ingredients whatever rules are made and whatever systems are employed. Experienced staff often have a sixth sense that something is wrong and needs investigation; they should follow their instincts. It is better to find that a transaction was after all legitimate than to miss stopping a fraud. Frauds do not come neatly labelled and packaged, but in all sorts of clever ways in which the evidence is deliberately fragmented and camouflaged.

Frauds often come at awkward times, for instance on the eve of a holiday or at a weekend, when there are many distractions and top management is dispersed and difficult to mobilize. The board should have in place a drill to handle such emergencies with named participants and reserves if some are unavailable. In practical terms this means the bank having at all times a duty officer who has the contact numbers for the named people.

The suspicion and confirmation of fraud is highly disagreeable (quite apart from the pecuniary consequences) because it so often implicates officials of the bank who have hitherto received colleagues' trust. Sometimes it will transpire that they had been subject to severe financial strain; occasionally they may have been blackmailed; they may simply have been greedy or impatient; or just bored and susceptible to suggestions from or coercion by a third party inside or outside. They may defraud to support a cause in which they passionately believe - even terrorist activity. None of these is an excuse for criminal activity. Frauds are just as likely to be committed by new employees who may feel they have little to lose, as by trusted long-standing employees who have access to a bank's most secure places.

Finally, the directors may have great confidence in the systems the bank operates - and this confidence may be based on the absence of significant fraud for years. All the more reason to look diligently at measures of prevention and get objective and periodical reports on vulnerability.

### **Prevention**

Prevention is better than cure; getting the money back is usually difficult. The directors should ensure that staff work in ways designed to reduce the risk of fraud by requiring:

- Care at the point of recruitment. This includes getting sound references from trustworthy people and being certain that there is nothing in the applicant's background that could put him under pressure or infer untrustworthiness. There should also be a credit check.
- That staff at every level, including directors, take two consecutive weeks holiday away from the bank every year.
- The separation of functions. Dealers for instance should never settle their own transactions. *'The front office should always be separate from the back office'*.
- The 'four eye' rule. Certain transactions should always require the participation of two people.
- That traders dealing in different time zones, sometimes from home or elsewhere off premises on mobile phones should keep adequate records. There should be independent confirmation of trades by the parties' back offices. Such business is an inevitable consequence of Globalization.
- That there are special measures to cope with the risks posed by IT:
  - (a) Ensure there are written standards governing access to and the use of computers to protect them from improper use or unauthorized access (however innocent). This includes restricting physical access to the area in which the computer is installed. The standard should also cover the operation of a secure library including access to it.
  - (b) Ensure the system provides a full audit trail. This includes recording the telephone numbers of access calls (and where possible restricting access to specified telephone numbers). It should also cover records like magnetic disks and tape and 'floppy' disks.
  - (c) Require management periodically to check that standards are being met and are effective.

## **Discovery**

Directors need to satisfy themselves that all the bank's staff are alert to the possibility of fraud by encouraging and rewarding those who successfully prevent it or display special acumen in identifying it. (*Examples could be complex - or simple, like forging the contents of cheque by altering the payee or amount or both. Forgery has become a fine art. A bank can now use highly sophisticated means of detection but the forger too has technology on his side*). Directors need to ensure that employees are up to date in their procedures for checking and authenticating documents and that they have the latest technology at their fingertips and know how to use it.

Directors also need to provide for the difficulty in which an employee finds himself when it is the action of a colleague or superior in the course of work that arouses his suspicions. There may also be something outside - for instance a sudden and unexpected change in someone's lifestyle. He needs to be able to discuss his concern (which in the end may prove groundless) with a trusted senior member of staff, quite possibly a director, who will not betray him. Directors should consider nominating such a person and telling all employees about confidential access to him.

In the normal course of business many mistakes and irregularities occur, and most when examined prove innocent and are rapidly remedied. Even when there is a suspicion that the irregularity is not innocent and that fraud may be a possibility a manager may be reluctant to treat it as such. He may fear that he will look foolish if it transpires there is no fraud and incompetent if there is. He may be reluctant to point the finger of suspicion at a colleague. Or he may simply not believe the evidence - paradoxically if the sums are very great. *A good maxim is 'When in doubt suss it out'.*

There should be a procedure in place to enable managers to obtain advice and assistance from in-house accountants (or other professional help) in interpreting the facts and transactions that have given rise to suspicions. With such a policy in place false alarms should be treated graciously as evidence of vigilance and conscientiousness.

### **Remedial action**

Directors have several objectives when fraud is confirmed:

- To stop it.
- To take remedial action to repair the damage.
- To prevent its happening again.
- To remove the perpetrators (if they are employees).
- To assist in the prosecution of the criminals.

First steps:

- Put a senior manager in charge of the case. *(This provides the necessary authority for instructions and also the contacts with top management).*
- Preserve the evidence, documentary and computer based. *(This may mean impounding laptops to prevent their being cleaned).*
- Take remedial action to change procedures and systems that have proved vulnerable *(and inform the audit committee.)*
- Organize the investigating team. Familiarity with the bank's structure, procedures, and personalities is an asset. Internal audit may have an important contribution to make. Some questioning at this stage is inevitable but it should be conducted by a senior manager accompanied by an observant and responsible colleague and carefully recorded (time, place, duration and content of interview).
- Inform the regulator of any significant fraud.

### **The police**

At the right moment the police (in the UK, the National Criminal Intelligence Service (NCIS) or where appropriate the police) should be informed. The timing is a matter of

judgment after the preliminary investigation reveals that the existence of a fraud is certain or highly probable.

At this point the questioning of suspects is best left to the authorities who will wish to determine the facts, preserve the evidence (for trial later) and locate stolen funds.

It may be however that the authorities have become aware before the management of the bank that a fraud was planned or already under way. They may refrain from action in order to catch the criminals red handed and obtain the evidence to secure a conviction. Whilst this is legitimate, the authorities should take account of the bank's commercial imperatives - safeguarding its assets and removing as quickly as possible employees who threaten them- and do all in their power to minimize the potential loss to the bank without jeopardizing their chance of securing a conviction. This is an area of great sensitivity and calls for tact, trust, and co-operation between bank and the authorities as their interests are not identical. If the authorities become too heavy handed they reduce the probability of matters being reported to them in future that look in any way doubtful. A bank may be put in vulnerable position if the authorities wish it to freeze money in a 'dubious' account but at the same time insist that they do not alert the client to the fact they are under suspicion. Quite apart from the fact that this may open the bank to suit for damages, the mere act of refusing to pay money out itself sends a signal. This is an area which requires further legal clarification.

### **Mistakes**

Much money is lost every year by mistakes, such as funds being transferred to the wrong accounts or errors in booking. Such losses cannot be insured so the imperative is to avoid making them, and identifying them and reporting them as soon as possible if they do occur. The longer the delay in doing so, the greater the danger that the loss cannot be avoided or mitigated.

## **ANNEX 3 - MONEY LAUNDERING**

### **Background**

Money obtained from crime is tainted and subject to confiscation by the authorities; 'crime' includes terrorism, extortion, blackmail, theft, tax evasion and drug offences. To avoid this risk its owners 'launder' it by passing it through financial and business institutions in such a way that it appears 'clean'.

Serious laundering is conducted by organized crime which will stop at nothing to attain its ends and uses coercion and bribery as means of doing so. It can afford the best brains to circumvent IT systems and is adept at finding original solutions when its way is blocked. Laundering is increasing to epidemic proportions. It can ruin the reputation of banks who are found to be a soft touch. It threatens legitimate enterprises - and whole communities, even states. So grave is the threat that the G10 countries formed a Financial Action Task Force (FATF) to counter it. It has issued 40 recommendations.

The directors are legally obliged to do all they can to prevent laundering and their staff are similarly obliged to help them. They should acquaint themselves with the main provisions of any relevant money laundering regulations (in the UK the Money Laundering Regulations 1993) but also be aware that changes are or may be on the way. The regulator may require a bank to appoint a senior officer with special responsibility to report money laundering. In the UK the post is called Money Laundering Reporting Officer (MLRO). Depending on the size and organization a MLRO may be a member of a section housed within the internal audit unit or with other control units or it may operate separately. In a big bank a MLRO will have subordinates. Wherever located he is the bank's focal point in the combat against laundering. The directors should know who he is and satisfy themselves he has effective reporting lines.

The responsibilities of a MLRO are:

- To understand what the official requirements are, and to familiarize himself with the subject and the latest developments. If in doubt he should seek advice from the regulatory authority. In the UK the FSA or if appropriate the NCIS.
- To make sure that management has prepared and promulgated policies which reflect official advice and that the relevant staff have received training in identifying dubious transactions and deposits. They will have been made aware that money laundering is usually a three stage operation:
  - (a) Placement - putting the funds into the system.
  - (b) 'Layering' - the use of a series of apparently normal transactions to disguise the original source of the funds.
  - (c) Integration - mixing the tainted funds with clean money so it becomes difficult to distinguish them.

He (and his staff) will have been shown how to use the relevant computer programmes that identify transactions that are unlike the usual pattern for that

client and others that draw attention to disaggregated transactions. It is a common launderers' practice to divide their funds into relatively small sums so as to escape notice.

Staff should be trained to recognize suspicious deposits and instructed in the drill for reporting them. Speed is of the essence. Tainted money does not linger. They must feel totally confident that blame will not attach to them if a dubious transaction turned out to be legitimate after all. They must also be trained to act circumspectly so as not to arouse the suspicion of the 'dubious' party. A suspicious deposit should be reported (in the UK to the NCIS) and the money in it frozen until released by (the NCIS or) the police. It cannot be stressed enough that account opening procedures are crucial. As a general rule the official should meet the depositor face to face This is one aspect of the basic rule - KNOW YOUR CUSTOMER

There is a great temptation to accept deposits coming out of the blue without enquiring too closely where the funds originated. This is unacceptable. The bank official concerned should check the provenance of the funds concerned and watch out for changes from the initial pattern - like depositing millions after some modest beginnings to the account.

All this requires judgment. The bank does not wish to deter legitimate business. The task therefore is so to conduct affairs that sensitive enquiries illumine suspicious circumstances without upsetting the honest.

- To liaise with the auditors about the adequacy of the bank's arrangements in the light of periodic checks. Of course if the auditors encounter suspicious circumstances in the course of their work they should notify the bank's management at once.
- To liaise with the bank's IT specialists about systems design so as to incorporate wherever possible programmes to counter laundering.
- To liaise with management about rewards for employees who are especially diligent in the identification and reporting of money laundering, and penalties for those who are negligent or criminal.

## **ANNEX 4 - INSURANCE**

### **General**

Directors are of course aware of insurance as part of their ordinary lives. They may be less aware of the large part it can play in mitigating the effects of risk in a bank. Some of the main uses are listed below. Identifying the need for insurance and arranging cover are among the duties of the Risk Management Committee as noted above. Personal liability cover for the directors however is a matter for the board itself.

Insurance is itself costly; not all risks can be readily insured anyway, for example booking errors, transfers to wrong accounts, failure to post a transaction correctly, unauthorized trading. Some risks are uninsurable. There is, in other words, no substitute for sound systems, care, diligence and rapid reporting which leads to prompt remedial action.

### **Standard risks**

It goes without saying that a bank will want to cover itself for standard risks like fire, robbery, cash in transit, and so forth. An area that merits particular attention is IT in all its many aspects. These and several other categories like consequential loss should be regularly reviewed by management to make sure cover is adequate and that rates are competitive. Decisions to carry one's own risk should be endorsed by the risk management committee and if material enough by the board itself.

### **Personal liability**

This concerns the liability of directors and officers and not the bank itself. It is dealt with by Directors' and Officers' insurance (D&O) and covers their alleged negligent acts and omissions etc. The bank pays the premiums and indemnifies the directors and officers; where this is not possible for regulatory, financial or legal reasons, insurers indemnify the directors and officers direct. This kind of cover is important as its absence might deter outsiders joining the board since all their personal assets might be at risk. The standards of care and knowledge expected of non-executive directors are rising and so is the range of responsibility they now bear. Consequently they are more at risk and premiums have risen.

One growing source of D&O liability is employment actions, especially, but not exclusively after mergers and acquisitions. Another is environmental claims where the trend is for the law to make directors personally liable.

### **Professional indemnity**

This policy is designed to protect the bank itself against litigation alleging damage through the bank's negligence, errors, omissions, and mis-statements, made by employees. The scope of the cover will be set out in the contract and it is essential to know what it is as there may be significant exclusions. Typical areas for cover might be advisory services, (a growing segment) custodian relationships, trust or brokerage.

Care should be taken to ensure that the policy is appropriate for the jurisdiction and legal system in which the activity takes place. Especial care should be taken to ensure that operations in foreign countries are adequately covered by insurance for the risks there, bearing in mind the laws, business practices, political and social conditions, and propensity to litigate in that particular market.

### **Lender Liability**

Such cases are rare though occasionally a bank faces a claim for breach of contract or negligence.

## **ANNEX 5 - ACCOUNTING AND AUDITING STANDARDS**

The freer flow of capital in recent years has greatly increased cross-border investment. This in turn has put pressure on the regulatory authorities and the accounting profession to move towards greater uniformity of accounting standards, a common language so to speak, so that users of accounts know that common conventions apply and that sets of accounts do not have to be re-interpreted according to the country of origin. This is a slow business however as some of the differences are substantial and are linked to differences in the tax regimes and beyond that to the national psyche. Hiding reserves for instance is much more prevalent in some countries than others and the laws reflect this.

As this process is a slow one directors in all jurisdictions should hold fast to the principle that the accounts should not only comply with the law but also give an honest and accurate account picture of the bank's position and performance.

The directors of banks throughout the world need to be aware of the general tendency towards uniformity (however slow progress is) and to make sure their auditors keep them abreast of developments and the way it will affect them.

The same tendency is observable with regard to auditing standards and the same caveats apply.

## **ANNEX 6 - AN ETHICS STATEMENT**

Directors may wish to issue a simple statement on ethical policy to the bank's staff. The following might be adapted to the bank's particular needs.

### **General**

Our policies, products, and behaviour conform in spirit as well as in law to the highest moral principles.

### **Our approach**

We approach all our relationships on the basis that they will be long term. This means that we conduct them honestly and scrupulously. We do not take advantage. We do not deceive. What we say we will do, we do. If we are prevented we say so as soon as we know. We know that business depends on trust. We do all we can to earn it and nothing to impair it. The quality we aim at in all our dealings is integrity.

### **The bank**

We all depend on the bank. We try to protect and enhance its name and reputation and we do not act in ways that would bring discredit on it. We keep its secrets secret. If we are faced with a conflict of interest we declare it. We look after its assets as if they were our own.

### **Colleagues**

We do all we can to ensure that colleagues are treated properly and given every chance the bank can offer to realise their full potential. We work within a team and do all we can to support other members of that team and of other teams in the bank. We do not let personal ambition drive us into behaviour of which we would be ashamed if it were known. If we are leaders at any level we set an example knowing that what we do and refrain from doing are as important as what we say.

### **Community**

We observe the laws and regulations to the letter in our own country and in any country in which we do business. We respect the local community in which we work and try to add to its coherence. We have regard for and respect the environment. We encourage colleagues to play their part in the community.

### **Customers**

Whatever others do, we do not bribe to obtain or keep business. If we pay commissions they must appear on the face of the documents. We look after customers as if they were there for ever; we compete for their business as if they would leave tomorrow. We do not accept bribes. We keep their secrets (within the limits of the law.) Our services meet our description and all relevant standards. We

know that the bank's position in highly competitive markets means we must deliver value and service. These can always be improved and that depends on our making whatever personal contribution we can.

### **Shareholders**

We remember their interests and try to protect them. We do not waste their assets or give them away without their permission. We keep them accurately informed. The accounts we present to them are reliable, truthful, accurate, and complete. We try to paint as clear a picture as possible of the bank's position and prospects. There are no 'off books' transactions.

*Whenever we are in doubt about an action, we test it by asking ourselves whether we would like it to be brought to public attention and be an object of comment. Would we like to see it reported in the press?*