INTRODUCTORY BANKING

Lecture 12 – Corporate Governance in banks, Building blocks of banking regulation and supervision

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Key terms of Lecture 11

- Banking regulation
- Basel capital accords
- Basel I, II, III, IV
- Calculation of capital adequacy ratio
- Bank capital

Content

What is corporate governance

The Basics of Corporate Governance (Investopedia)
Governance refers specifically to the set of rules, controls, policies, and resolutions put in place to dictate corporate behavior.
….
What is Corporate Governance?
Corporate governance is **the system of rules, practices, and processes by which a firm is directed and controlled.** Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

…… Specifically requirements for banks:
EBA Guidelines on Internal Governance EB/GL/2017/11:
Weaknesses in corporate governance in a number of institutions have contributed to excessive and imprudent risk-taking in the banking sector, which has led to the failure of individual institutions and systemic problems in Member States and globally. In order to address the potentially detrimental effects of poorly designed corporate governance arrangements on the sound management of risk, ….the EBA has updated its Guidelines on internal governance, originally published on 27 September 2011.

The Guidelines put more emphasis on the duties and responsibilities **of the management body in its supervisory function in risk oversight**, including the role of their committees. They aim at improving the status of the risk management function, enhancing the information flow between the risk management function and the management body and ensuring effective monitoring of risk governance by supervisors. The 'know-your –structure' and complex structures sections, especially following the 'Panama events', have been strengthened to ensure that the management body is aware of the risks that can be triggered by complex and opaque structures and to improve transparency. In addition, the framework for business conduct has been further developed and more emphasis is given to the establishment of a **risk culture, a code of conduct and the management of conflicts of interest**.

Corporate governance in banks

Role and responsibilities of the management body (from the EBA Guidelines on Internal Governance EB/GL/2017/11)

20. In accordance with Article 88(1) of Directive 2013/36/EU, the **management body must have ultimate and overall responsibility for the institution and defines, oversees and is accountable for the implementation of the governance arrangements** within the institution that ensure effective and prudent management of the institution.

21. The duties of the management body should be clearly defined, **distinguishing between the duties of the management (executive) function and of the supervisory (non-executive) function**. The responsibilities and duties of the management body should be described in a written document and duly approved by the management body.

Common approach to corporate governance in CZ, Central Europe („Continental approach“)

a) **Supervisory Board**

performs **oversight** of the efficiency and effectiveness of the bank’s internal control system and carries out an evaluation thereof,

specifies the principles for the remuneration of members of the board of directors,

usually establishes committees concentrating on specific areas (e.g. renumeration/nominating, audit, financial committees).

b) **Board of Directors**

is responsible for **establishing**, maintaining and evaluating an efficient and effective internal control system, **bears responsibility for the functioning of the bank**,

approves the overall and risk management strategy of the bank,

approves a functional organizational structure that reflects the requirements for the segregation of conflicting duties,

specifies and approves principles of employee and salary policy.

Continental approach to corporate governance

c) **Senior Management** shall **implement** the strategy approved by the Board of Directors.

Members of the Board of Directors and Senior Management may or may not overlap in person (e.g. Chairman of the Board of Directors and General Manager, or CEO, may or may not be the same person).

General requirements of the Supervisory Board and Board of Directors are set by Commercial Code, and by the Act on Banks, No. 21/1992 Coll. for banks only. Specific requirement are set by Decree No. 163/2014 Coll. on the performance of the activity of banks, credit unions and investment firms (since revision No. 392/2017 Coll. investment firms removed)

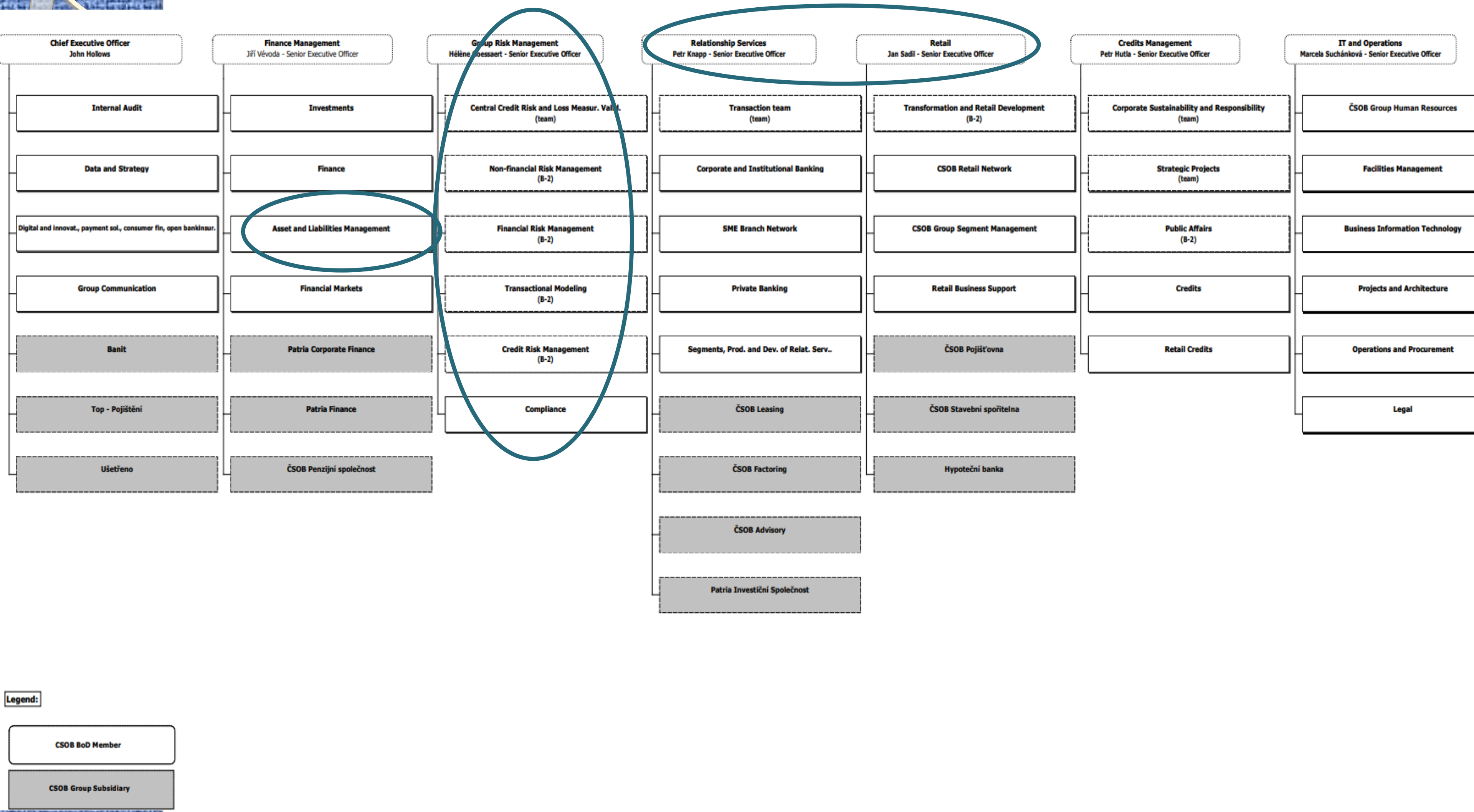
Segregation of conflicting duties

The bank shall ensure that the units, employees and committees of the bank are assigned responsibilities and authorities in such a way that potential conflicts of interest are adequately prevented.

Units that are responsible for the following activities **risk management** and e.g. settlement and reconciliation of financial market transactions may not be organizationally subordinate to senior management members to whom **business units** are organizationally subordinate:

See the organizational chart of ČSOB as of 1.4. 2021

Segregation of conflicting duties



Segregation of conflicting duties in the Loan granting process

- Loan/client acquisition
- Information collection
- Loan/client monitoring

- Loan/client assessment - valuation
- Collateral valuation
- Credit approval
- Loan/client monitoring
- Loan/client classification and provisioning
- (Work-out)

Other issues related to governance in banks

- **Internal Audit department**
- **Compliance department/function**
- **F/O** – front office ~ where the transactions are negotiated with the client (business units)
- **B/O** – back office ~ where the transactions are settled and reconciled
- **M/O** – middle office ~ where the market conformity of prices is controlled if transactions on financial markets are closed for market prices
- **Risk management department** ~ where the risks are monitored, (loan) transactions are independently evaluated and finally approved.
- **Potential conflict of functional vs. organizational subordination** – a typical issue for foreign owned banks: for example, a risk management department of a bank is organizationally subordinate to the General Manager of the bank, but functionally subordinate to and managed by the risk management department of the parent bank.
- **Banks versus branches** – banks are managed as an independent shareholder's company, branches as organizational units of foreign banks.

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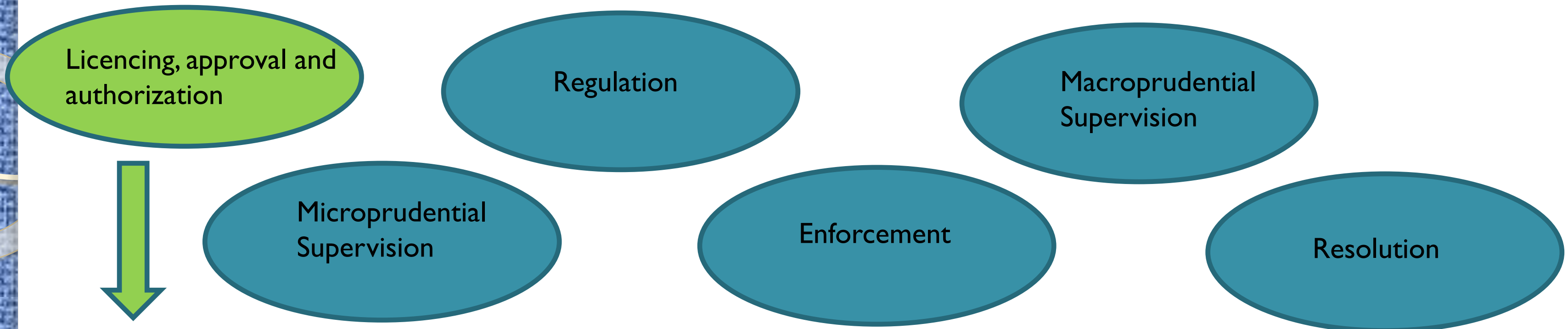
Basic regulation and supervision building blocks

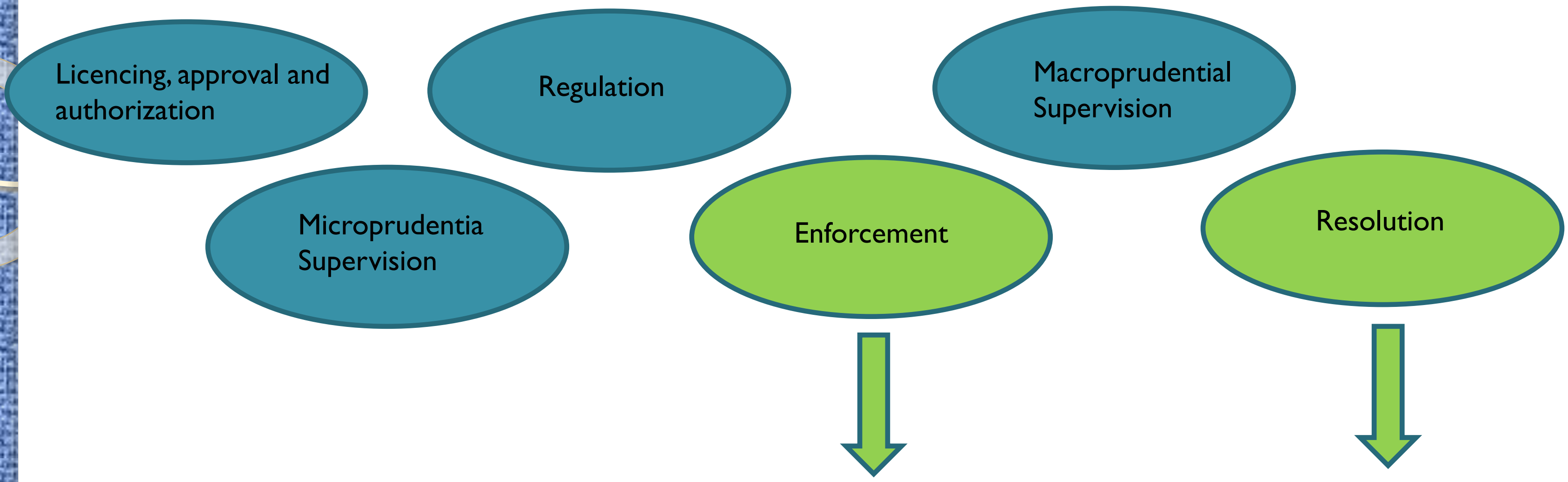


Proceedings and decision-making on licences, permits and approval applications

- **CAPITAL** – transparency of origin, preferably to ultimate business owner („UBO“)
- **PEOPLE** - persons having a qualifying holding, members of the statutory body must be trustworthy and competent, Fit & Proper procedure (questionnaire, CV, personal meetings)
- **BUSINESS PLAN** – institution must have a programme of operations proceeding from its proposed strategy of activities and based on realistic economic calculations;
- **INTERNAL ORGANIZATION AND RESOURCES** - Institution must have in place the technical and organisational prerequisites for pursuing its proposed activities and a functional and effective governance system

Licencing a bank or more complex institution – 2 years (also e.g. Supervision department involved)
Licencing a of a less complex institution, NBFI – 6 months – 1 year
Fit & proper procedure (Supervision may be involved) – 1 week – 2 months (longer when references from other institutions involved)

Basic regulation and supervision building blocks



Enforcement activities (i.e. proceedings and decision-making on licence, permit and approval revocation, on the cancellation of registrations and in matters regarding corrective measures - shortcomings or administrative offences identified in the financial supervision, including restrictions on permissible activities and proceedings on the imposition of conservatorship)

A **resolution** action using resolution tools and powers should be generally triggered only where necessary in the public interest (e.g. ensuring continuity of critical functions, protecting financial stability, minimising public support and protecting covered deposits) and liquidation or insolvency proceedings would not meet the resolution objectives and public interest to the same extent.

Basic regulation and supervision building blocks

Licencing, approval and authorization

Regulation

Macroprudential Supervision

Micropudential Supervision

Enforcement

Resolution

Microprudential supervision

Supervision on the level of individual banks

- Business model
- **<u>Governance</u>**
- Risk to capital
- Liquidity and Funding

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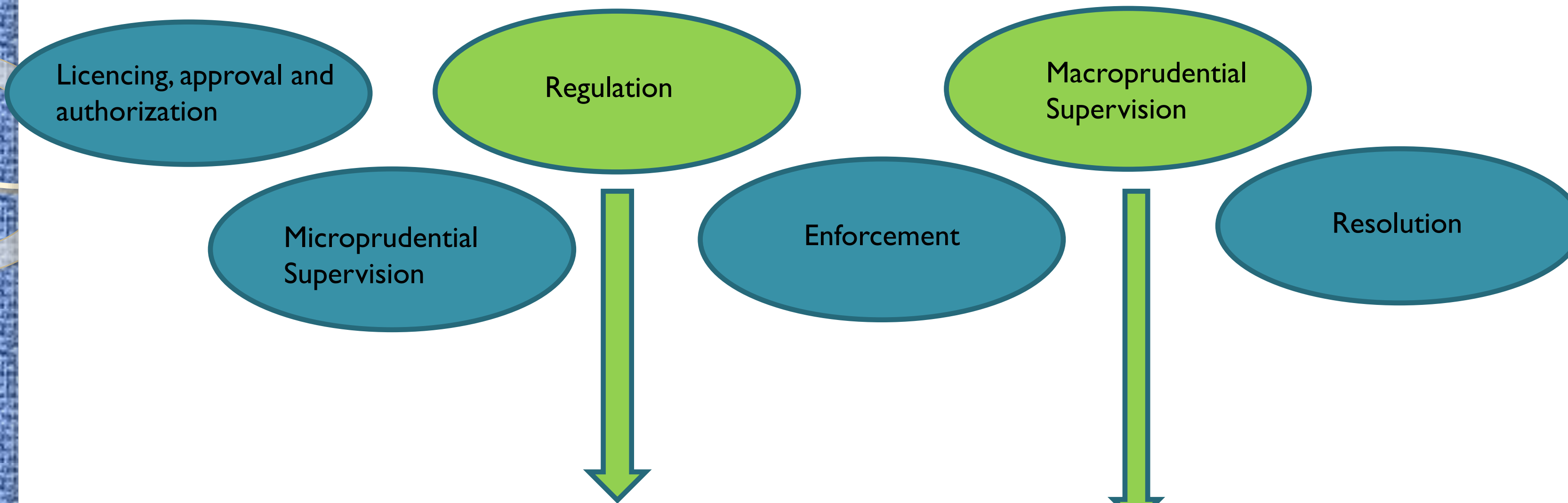
Conduct of business supervision – major concerns

- **Unfair business practices**
- **Consumer discrimination**
- **Consumer complaints**

AML supervision – on-site and off-site surveillance of AML procedures

Basic regulation and supervision building blocks



Regulation
Setting regulatory framework
National laws and enforceable regulation
Enforcable regulation based on Basel recommendations (e.g. EU Directives)
Additional guidelines, recommendation, explanatory notes, Q & As (are market participants co-operative ?)

The objective of macroprudential policy is to safeguard **financial stability** through the application of a set of instruments (e.g. via macroprudential buffers).
It is defined as a situation where the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy as a whole, while showing a high degree of resilience to adverse shocks (eliminating or decreasing systemic risk).