Chapter 2

International Developments

2.1 Forums & Committees Working on Corporate Governance

In the last decade lots and lots of work has been done on corporate governance all over the world. Both at International and national levels, government and non-government agencies and forums have done work on corporate governance. More is in the pipeline. In the fast integrating and complex global environment, it is expected that more literature will be published in coming days.

This chapter has been included in this handbook to give the reader a feel for the work and developments in corporate governance in the world around. These developments should be taken as a prelude to future developments which we shall endeavor to bring here in Pakistan.

Following committees and forums have enumerated standards, codes and principles for corporate governance:

a) Core Principles For Effective Bank Supervision issued by Basel Committee on Banking Supervision
b) Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance
c) Cadbury Committee on Financial Aspects of Corporate Governance
d) Kings Committee on Corporate Governance
e) Blue Ribbon Committee on Improving The Effectiveness of Corporate Audit Committees
f) European Association of Securities Dealers (EASD)–Corporate Governance Principles
g) Recommendations of The Committee on Corporate Governance (South Korea)

In the following pages, we have summarized the codes in the major areas where above mentioned committees have focused their work.

2.2 Board of Directors

✍ **Core Principles for Effective bank Supervision: Principle 14**

Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Essential criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.

2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organizational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address:
   - Organizational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).
   - Accounting procedures: reconciliation of accounts, control lists, information for management.
   - Checks and balances (or "four eyes principles"): segregation of duties, crosschecking, dual control of assets and double signatures.
   - Safeguarding assets and investments: including physical control.

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills

for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.

4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

Additional criteria

1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.

2. The supervisor requires the internal audit function to report to an Audit Committee.

3. In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors.

(Basel Committee on Banking Supervision)

✍ The Responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

a) Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

b) Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

c) The board should ensure compliance with applicable law and take into account the interests of stakeholders.

d) The board should fulfill certain key functions, including:
   - ✍ Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting

performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.
- Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
- Overseeing the process of disclosure and communications.

e) The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.

- Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.
- Board members should devote sufficient time to their responsibilities.

f) In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

(OECD Principles of corporate governance – 1999)

- Split role of Chairman and Chief Executive Officer.

(Kings Committee on Corporate Governance - 1994)

- Board to have formal schedule of matters and to meet regularly.

(Cadbury Committee - 1992)

Common Wealth Association's Principles are summarized as below:

Board should:

- Ensure that corporation will continue as a going concern.
- Exercise leadership, enterprise and judgment in directing the business.
- Set objectives and strategies of the organization.
- Ensure development of key policies and their implementation.
- Monitor, evaluate and review the aims, strategies, policies, etc.
- Form committees in key areas and ensure their functionality
- Ensure company's adherence to laws of the land, regulations and best practices.
- Ensure existence of communication web among all stakeholders.
- Ensure efficacy of systems, procedures and internal controls.
- Ensure working of a right blend of human and material (technological) resources.
- Ensure identification and mitigation of all risks.
- Set key performance indicators of the business enterprise.
- Ensure flexibility of structure, products and delivery to face the challenge of fast coming globalization.

2.3 Management

- Management should have sufficient latitude to propose and implement corporate strategy. Its incentives should, as far as possible, be aligned with those of the company and its shareholders as a whole.

(EASD: corporate governance principles - 2000)

2.4 Audit & Audit Committee

- **Core Principles for Effective bank Supervision: Principle 14**

  5. The supervisor determines that banks have an appropriate audit function charged with: Ensuring that policies and procedures are complied with and reviewing whether the existing policies, practices and controls remain sufficient and appropriate for the bank's business.

     The supervisor determines that the audit function:
     - Has unfettered access to all the bank's business lines and support departments;
     - Has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
     - Has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
     - Employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.

  6. The supervisor has access to the reports of the audit function.

(Basel Committee on Banking Supervision)

- Effective internal audit system should be in place.

(Kings Committee on Corporate Governance - 1994)

- Audit committee to have formal and written charter, approved by the full board specifying its structure, responsibilities, process and membership.

(Blue Ribbon Committee – 1999)

2.5 Financial Reporting

- Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

  Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

  (OECD Principles of corporate governance – 1999)

- Accounting standards in line with international standards.

  (Kings Committee on Corporate Governance - 1994)

- Relevant, timely, accurate and understandable disclosure should be made of material information necessary for the proper evaluation of the status and the situation of the company. Internal controls should provide for the integrity of corporate data. Independent verification and certification of the existence of appropriate controls and the integrity of data, in particular disclosed information, should be obtained to the fullest extent feasible.

  (EASD: corporate governance principles - 2000)

- **Core Principles for Effective bank Supervision: Principle 21**

  Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Essential criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.
2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.
4. The supervisor ensures that there are open communication lines with the external auditors.

5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.
6. The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.
7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.
8. The supervisor has the ability to treat as confidential certain types of sensitive information.
9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.
10. The supervisor has the right to revoke the appointment of a bank's auditors.
11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognized by the supervisor as having the necessary professional skills and independence to perform the work.

Additional criteria

1. The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.
2. The supervisor has guidelines covering the scope and conduct of audit programs that ensure that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitization, and the adequacy of internal controls over financial reporting.
3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.
4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters which, in the context of

the available information, they believe is likely to be of material significance to the functions of the supervisor.

(Basel Committee on Banking Supervision)

2.6 Code of Conduct, Business Ethics

- Observance of highest level of business and professional ethics.

(Kings Committee on Corporate Governance - 1994)

2.7 Shareholders

- The rights of shareholders to be protected.

(OECD Principles of corporate governance – 1999)

- Shareholders enjoy basic rights, which should be protected. They have a right to adequate and timely information and appropriate forms of participation in certain decisions affecting the company and themselves.

  Controlling shareholders should give due consideration to the interests of minority shareholders. Minority shareholders should not unreasonably restrain corporate action.

(EASD: corporate governance principles - 2000)

2.8 Stakeholders

- The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

  A. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.
  B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.
  C. The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.
  D. Where stakeholders participate in the corporate governance process, they should have access to relevant information.

(OECD Principles of corporate governance – 1999)

2.9 Corporate Governance Rating

- To establish sound governance structure within the corporation, financial institutions and credit rating agencies shall include the quality and efficiency of governance structure in evaluations when rating the credit of corporations.

(Recommendations of the committee on corporate governance - South Korea)