



ASSOCIATION OF SUPERVISORS  
OF BANKS OF THE AMERICAS

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# CORPORATE GOVERNANCE IN BANKING INSTITUTIONS

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2009

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# CORPORATE GOVERNANCE IN BANKING INSTITUTIONS

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GROUP 5

ASSOCIATION OF SUPERVISORS  
OF BANKS OF THE AMERICAS



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## | EXECUTIVE SUMMARY |

Corporate governance at banking institutions, if implemented in a sound and consistent way, becomes one of the pillars for maintaining confidence in a banking institution and in the banking system in general. The Association of Supervisors of Banks of the Americas (ASBA), aware of the importance of this issue for the stable development of banking systems in the Region and with the purpose of fostering the adoption of solid corporate governance frameworks in banking institutions, began in 2006 a wide discussion on this topic among its members and relevant multilateral institutions.

This document is one of the products of that effort, which was carried out by a Working Group comprised of representatives of ASBA Members. The document analyzes different elements of corporate governance based on the Corporate Governance Principles in the BIS document “*Enhancing Corporate Governance for Bank Organizations*,”<sup>1</sup> presents a regional overview of the treatment given to corporate governance and establishes good practices and specific recommendations.

The Working Group found that not all countries have a specific set of regulations on corporate governance. In addition, only a few countries have specific units within the bank supervision agencies charged with supervising corporate governance.

On the other hand, practically all the supervisory agencies that responded to the survey include analyses of corporate governance in developing a risk profile for the organizations they supervise. Nevertheless, while some supervisors perform a corporate governance analysis only to qualify the organization in the management area, others introduce this

analysis into a general matrix, making it part of a global risk assessment.

In summary, it can be said that the countries in the Region are very aware of the importance of having a robust corporate governance framework, and are working with different strategies and methods to create it.

The Working Group defined a significant number of practices and recommendations for the banking supervisor, among which the most important are those that follow.

1. A list of the ideal traits for members of the Board of Directors must be drawn up, and verification is necessary to ensure that Board members present these traits. Board members must offer experience and specific knowledge of the banking industry or of the operations the organization will perform, lack of prior sanctions owing to deficient management, a history of meeting credit obligations and the absence of a criminal record.
2. The supervisor must verify that formal mechanisms exist for communicating throughout the institution the policies, decisions established by the Board of Directors and senior management as well as the strategic objectives, corporate values and lines of responsibility established by the Board of Directors. In addition, the supervisor will verify that mechanisms also exist to ensure proper follow-up actions are taken on policies and decisions.
3. A code of ethics or conduct approved by the Board of Directors is necessary, and must include the organization’s values, standards of conduct for staff members

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<sup>1</sup> *Enhancing Corporate Governance in Bank Organizations*. Basel Committee on Banking Supervision. BIS. February 2006

and rules regarding possible conflicts of interest and the means of preventing or resolving such conflicts. This code must be widely disseminated throughout the organization.

4. The different goals for each time period must be established for the various divisions of the institution. Periodic management reports must be reviewed to verify that the objectives are met, and if they are not met, to determine the reasons for non-compliance. In this regard, it is necessary to review the methodology used by the organization to follow up with the individuals responsible for execution and completion of approved plans.
5. The financial institution's statutes must establish the obligation of senior management to be accountable to the Board of Directors regarding compliance with board policies, follow their instructions, implement the strategic plan, allocate the budget properly, and carry out adequately all actions necessary to fulfill the organization's objectives in compliance with the policies approved by the Board of Directors.
6. It is necessary to verify that the Board of Directors and senior management are committed to a strong culture of control. Also,

it should be verified that the internal auditor does not perform any other duties within the organization, and that he does not participate in or authorize operations that are to be audited. The internal auditor must report to the Auditing Committee, and not to senior management, in order to ensure that managers to be audited do not interfere improperly in the work of the auditor.

8. It must be established in the institution's statutes that the Board of Directors, through a Compensation Committee, will be responsible for setting remuneration policies for senior management. This Committee must be independent and have relevant experience and should not be influenced by the bank's CEO. Payment policies must not establish inappropriate incentives that push senior management to take excessive risks or that reward in excess short-term results.
9. Public disclosure must be actively promoted, whether by legal requirements or by issuing disclosure standards. It is necessary to give special attention to areas where the requirements of stock markets and accounting reports are insufficient.

## | INTRODUCTION |

In any economic sector, mutual trust between the various participants is essential for smooth-running operations. Transactions are based on the compliance with established rules and the terms of contract agreements. Given the nature of the banking business, where there is a mismatch between deposits and loans and where balances depend on the decisions of different economic agents, trust becomes even more relevant than in other sectors.

A preponderant factor in building and maintaining trust is having a proper corporate governance framework in place in banking institutions. On many occasions, failures of corporate governance have led to bankruptcy, causing major fiscal expenses owing to the impact of deposit insurance schemes on the public budget.

Similarly, an inadequate corporate governance framework at a banking institution could create an image of lack of ability to manage properly its assets and liabilities. This could trigger a gradual migration of deposits to competing institutions and, in extreme cases, a run on the bank.

Given these types of risks, bank supervisors should promote the development of appropriate corporate governance frameworks at banking institutions that would contribute to a safe, stable and transparent working environment and protect depositors.

In this respect, ASBA, in pursuit of its objective of establishing and disseminating good bank supervisory practices and regulations, and aware of the importance of strengthening corporate governance at banking institutions, established Working Group 5. The objective of this group was to create a document that 1)

presented the state of corporate governance supervision and regulation at banking institutions in the Region and 2) identified best practices for supporting the application of a proper regulatory and supervisory framework of corporate governance among Associate Members.

It is important to note that this effort has a precedent. During 2007-2008, Working Group 4 prepared a document entitled “Corporate Governance in Bank Supervisory Agencies.” This document analyzed, among other topics, the objectives and organizational and governance structure of a supervisory agency, the composition of governance organizations (appointment, tenure, removal, requirements to be fulfilled, conflict of interest, etc.), the use of codes of conduct, transparency and accountability within the supervisory agency, independence of the supervisory agency and legal protection of the supervisor.

At that time, ASBA believed that a first step for decisively fostering corporate governance measures at banking institutions was to establish a commitment to corporate governance supervisory agencies. An attempt was made to achieve this by issuing a document that promoted corporate governance among supervisory agencies of Associate Members.

Once this precedent was established, ASBA sought to carry out a complementary effort, developing an analysis of the current practice of supervision of corporate governance in the banking sector of the Region and defining good supervisory and regulatory practices for this field.

Through this document, the Working Group aims to provide supervisors with a practical guide for evaluating the strength of the

structure and components of corporate government at banking institutions in their jurisdictions.

The document is divided into eight chapters. The first chapter provides a definition of corporate governance and some general principles, while the second chapter presents an overview of the structures of corporate governance supervision in the Region. The third chapter discusses the supervision of traits of the members of the Board of Directors and their knowledge of their organization's structure, while the fourth chapter treats the issue of supervision of the role of the Board of Directors in establishing and communicating strategic objectives, corporate values and lines

of responsibility to the rest of the institution and the supervision of accountability.

The fifth chapter discusses the supervision of the role of the Board of Directors in verifying the performance of senior management and its compliance with policies established by the Board, while the sixth chapter addresses the supervision of the role of the Board in promoting sound internal controls and the work of auditing firms. The seventh chapter addresses the topic of supervision of a compensation policy consistent with the institution's corporate culture, strategy, and objectives, while the eighth chapter reviews the supervision of transparency in the management of banking institutions.

# CHAPTER 1

## Definition of Corporate Governance and General Principles

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The OECD<sup>2</sup> defines corporate governance as “a series of relationships between the organization’s management, its board members, its employees and other individuals with interests in the activities of said organization.” Consequently, corporate governance is a set of principles and standards that regulate the design, composition and functioning of the governing bodies of an institution.

The Corporate Governance Principles, established by the BIS<sup>3</sup> in its document Enhancing Corporate Governance for Bank Organizations, were used as the basis for this document. The BIS establishes the following.

- Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
- The board of directors should approve and oversee the bank’s strategic objectives and corporate values and ensure that they are communicated throughout the banking organization.
- The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization.

- The board should ensure that there is appropriate oversight by senior management consistent with board policy.
- The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions.
- The board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long-term objectives and strategy, and control environment.
- The bank should be governed in a transparent manner.
- The board and senior management should understand the bank’s operational structure, including where the bank operates in jurisdictions or through structures that impede transparency.

In general, the presence of a proper corporate governance system at an institution contributes to an increase in trust among the different stakeholders interested in the institution’s performance because a governance system creates the mechanism for aligning management’s objectives with those of the stockholders and remaining stakeholders.

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<sup>2</sup> OECD: Organisation for Economic Co-operation and Development).

<sup>3</sup> BIS: Bank for International Settlements.

## CHAPTER 2

# Overview of the Structure for Supervision of Corporate Governance in the Region

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This chapter presents an overview of the characteristics of the corporate governance supervision structure in countries of the Region using the information provided by ASBA's survey. The units responsible for supervising corporate governance processes are described. In addition, the main factors considered in the

analysis of corporate governance are summarized, and the inclusion of this analysis in the comprehensive risk analysis is explained.

It is important to point out that not all the countries have a systematized framework to deal with corporate governance.

## 2.1

### UNITS RESPONSIBLE FOR SUPERVISING CORPORATE GOVERNANCE

In general, there is lack of uniformity among agencies of the Region regarding who supervises corporate governance and whether there are specific units responsible for this. The structures in charge of this task respond to the institutional features of each supervisory agency.

#### ARGENTINA

Supervisory Management Offices are the units responsible for the supervision of corporate governance. They perform this task through on-site and off-site supervision. The Management Office for Standard Compliance, the Management Office for Authorizations and the Management Office to Control Auditors also participate in this process.

#### BOLIVIA

There is no specific analysis regarding the adoption and application of good corporate governance practices and policies.

#### BRAZIL

At the licensing stage, the Deputy Governor of the Regulations and Organization of the Financial System (*Diretoria de Normas e Organização do Sistema Financeiro*) reviews issues related to corporate governance, among other issues, prior to granting a license.

The Deputy Governor of Supervision (*Diretoria de Fiscalização*) is responsible for on-site supervision of corporate governance.

#### BRITISH VIRGIN ISLANDS

The Banking and Fiduciary Services Division is responsible for supervising the corporate governance structure at banks.

#### CANADA

At the OSFI<sup>4</sup>, the Relations Manager is responsible for assessing corporate governance. This work is performed through two supervisory structures: large banks (financial conglomerates) and small banks (financial institutions).

#### COLOMBIA

The Office for Conglomerate Risks and Corporate Governance (*Delegatura para Riesgos de Conglomerados y Gobierno Corporativo*), through the Office of Corporate Governance, is in charge of supervising corporate governance at supervised organizations.

In this regard, the Office of Corporate Governance is in charge of the following:

- a) Follow up and evaluate corporate governance at supervised institutions, including those that belong to a conglomerate.
- b) Verify the proper functioning of the various organizations that make up the corporate governance structure.

In order to do this, the Office of Corporate Governance has full supervisory authority to

<sup>4</sup> OSFI: Office of the Superintendent of Financial Institutions.

perform inspection visits, give orders, interrogate relevant officials, bring charges, issue definitions, answer queries, etc.

#### EL SALVADOR

The Department of Corporate Governance is the unit responsible for performing assessments of corporate governance in the financial sector.

#### JAMAICA

There is no unit or department devoted exclusively to assessing corporate governance. Reviewing corporate governance is included as part of the on-site and off-site supervision of financial institutions.

#### NICARAGUA

Among its responsibilities, the Office of Consolidated Supervision is in charge of assessing corporate governance of financial groups. Organizations that do not belong to any financial group are assessed by the Off-site Office of the Bank Intendence (*Dirección Off-site de la Intendencia de Bancos*) or by any of the other intendance offices.

#### PARAGUAY

The Intendency Office for Financial Analysis is responsible for checking compliance with the principles issued by the Basel Committee through on-site and off-site inspections.

#### PERU

The Superintendency of Banks and Microfinance (*Superintendencia Adjunta de Banca y Microfinanzas*) is in charge of supervising corporate governance processes at banking institutions.

#### PUERTO RICO

The department of *Analysis of Deposit Institutions* is responsible for assessing and supervising corporate governance processes at banking institutions.

#### SPAIN

The inspection teams of the *Banco de España* are responsible for reviewing corporate governance through on-site and off-site supervision.

#### UNITED STATES

Banking supervision agencies in the United States (Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, Office of Thrift Supervision and state bank authorities) have a team of supervisors that make annual on-site inspections at every insured financial institution. In addition, every agency performs off-site inspections between every on-site inspection.

In sum, only a few countries have a specific unit charged with assessing corporate governance.

## 2.2

### FACTORS CONSIDERED WHEN EVALUATING CORPORATE GOVERNANCE

In general, the factors taken into account by the different supervisory agencies when analyzing corporate governance are quite similar.

#### ARGENTINA

The supervision process considers those factors that have an impact on the design and functioning of the control structure, such as: the risk management framework, the infra-

structure and the information systems, the internal and external audits, the division of labor, the organizational structure and strategic planning.

#### BRAZIL

All topics studied in this document are reviewed, including the nomination and removal of external auditors and the nomination

and removal of directors who report to the Central Bank on issues of accounting, auditing, and market, credit and operational risk.

#### CANADA

The on-site and off-site corporate governance supervision analyzes the following:

- effectiveness of performance of the Board of Directors;
- effectiveness of indicators;
- risk management;
- internal audit;
- other activities independent from supervision (external audit);
- governance at subsidiaries and *holding* companies and
- independence of the Board of Directors.

#### COLOMBIA

A process to supervise corporate governance has been developed, which covers the following:

- ownership structure;
- Board of Directors;
- management;
- control mechanisms;
- disclosure of information;
- control by management;
- rules dealing with good governance and
- relationships with stakeholders

There are also procedures for on-site and off-site supervision that include the preparation of a diagnostic report about one or all of

the aspects of governance of the supervised organization.

#### EL SALVADOR

The assessment of corporate governance is composed of two processes. The objective of the first one is to learn the strategic, operational and business plans of the financial institution, as well as its structure for corporate governance and control.

The objective of the second process is to assess the existence and implementation of specific mechanisms of corporate governance. This process reviews the following:

- stakeholders;
- ownership structure;
- shareholders' officers and their rights;
- Board of Directors;
- senior management;
- control mechanisms;
- control of the administration of corporate governance bodies;
- information disclosure and
- self-regulation of corporate governance.

#### JAMAICA

The main components of corporate governance that are assessed include:

- an adequate and proper review of majority shareholders, directors, and managers, when the bank license is issued;
- evaluation of the organizational structure;
- policies and procedures of corporate governance, in accordance with the nature of the institution;

- mechanisms used by the Board of Directors and management to perform their tasks;
- the contribution of internal and external auditing to risk management and
- annual meetings with the directors of financial organizations.

#### PARAGUAY

The main aspects that are reviewed when analyzing corporate governance are: the management capacity of the Board of Directors, the presence of formal rules about establishing appropriate governance structures, the definition of policies, strategies, and objectives in documents, etc.

#### PERU

In evaluating corporate governance, on-site and off-site analyses are performed. Related to this, there is specific guide for an on-site supervision titled, “Assessment of Government Organisms.”

Off-site procedures cover items that verify the suitability of directors and senior managers, including the revision of their credit history in the financial system and history in management in other financial institutions (possible sanctions) through the Record of Penalties of the Superintendency. The aspects of corporate governance that are assessed include the following:

- independence and technical suitability of the entities;
- culture of ethics and control;
- the regime of functions and responsibility and
- the internal control system.

#### PUERTO RICO

Corporate governance processes are assessed using the *Handbook of Exams* and through ap-

plying a module or questionnaire titled *Assessment of Internal Controls and Management*. The elements reviewed include the following:

- the process of selection and qualification for directors;
- powers and responsibilities of directors;
- rules that apply to the areas of bank operations that relate to banking secrecy and preventing money laundering;
- policies that allow executive officers to operate and safeguard the institution’s assets and
- compliance with applicable laws and regulations.

#### UNITED STATES

The main elements of corporate governance that are assessed during on-site inspection are:

- board and management objectives and strategies;
- organizational and personnel structure;
- adherence to policies and procedures;
- internal controls, auditing programs and risk management systems and
- transactions with affiliates and shareholders and loans to directors and executives of the organization.

Off-site supervision is useful, in part, to evaluate corrective actions and monitor financial and management changes.

## 2.3

### INCORPORATION OF CORPORATE GOVERNANCE IN THE GENERAL RISK ANALYSIS OF SUPERVISED INSTITUTIONS

In general, practically all supervisory agencies that answered the survey include the analysis of some aspects of corporate governance in the risk profile of supervised institutions. Nevertheless, there are some differences. While some perform the corporate governance analysis only for qualifying the institution in the management area, others introduce the analysis into a general matrix, making it part of the global risk assessment.

#### ARGENTINA

The quality of corporate governance at a financial institution is taken into consideration when evaluating the categories of “Management” and “Internal Control” within the CAMEL BIG<sup>5</sup> assessment system. The corporate governance system is considered essential to qualify both of these components which are decisive in the final score of financial organizations.

#### BRAZIL

Assessment of corporate governance is incorporated into the risk profile of an institution through a *rating* process called “System of Evaluation of Risk and Control” (SRC) which evaluates the risks and controls of a financial institution.

#### CANADA

Corporate governance is analyzed within the process of analyzing risk management, so it is considered an element of global risk.

#### COLOMBIA

Currently, the *Office for Conglomerate Risks and Corporate Governance* performs a diagnosis of the state of the governance and control bodies of each institution, reviewing the items mentioned in the previous section. From this assessment, a risk qualification is obtained (low, medium low, medium high, and high).

The other *Risk Offices* (for credit, market and operational risks and asset laundering) analyze the management of governance and control bodies for each supervised institution, and produces an evaluation that includes a rating. These ratings are incorporated into an individual matrix by risk segments, which produces a global qualification for each institution.

With those two essential components, the supervisor obtains the general view of the corporate governance risk of each institution.

#### JAMAICA

The quality of corporate governance is rated as part of the supervision of global risks at the institution. The Bank of Jamaica has issued different standards of good practices for reviewing how different types of risk are managed.

#### PARAGUAY

The assessment of corporate governance is included within the evaluation of qualitative aspects of an institution. The incorporation of these aspects into the organization’s risk profile is still not practiced in a meaningful way. This is due to the lack of relevant norms.

#### PERU

Corporate governance is verified at the time the organization’s risk profile is evaluated, as part of the Management and Control component, specifically as it relates to Suitability of Management and Corporate Governance. These items, among others, determine the internal rating of the institutions of the financial system.

A general risk map is being developed to reinforce the scheme for rating banking institutions which will make it possible to system-

<sup>5</sup> CAMELB: *Capital, Assets, Market, Earnings, Liquidity, Business*. IG: *Internal controls, management* (Management.)

atize the principal risks of banks. The map will serve as preparation for on-site inspection visits, and will identify each of the deficiencies by type of risk and will point out its impact on the bank. This tool will map all the identified risks by their degree of importance.

#### SPAIN

The risk matrix is the way that the Bank of Spain synthesizes the process for determining a risk profile. Knowledge of the power structure at a banking institution has two facets that are meaningful for the supervisor.

Firstly, knowledge of the power structure is basic in making an assessment of the risk management system at a banking institution since it depends on the definition from the Board of policies for assuming risks and the compliance mechanisms. The review is carried out in every supervised business area, and the benefits of corporate governance are rated based on risk policies followed in practice, the degree of compliance with guidelines issued by government units and the adequacy of the controls established for monitoring risk management. The assessment is incorporated into the risk matrix within the sections of inherent risk and controls.

In the second place, knowledge of the power structure relates to the fact that corporate governance must assess areas such as shareholders, by-laws, the rules and effective operation of the Board and its commissions, the attitude of the supervised institution towards the supervisor and market transparency.

Both of these facets are relevant in establishing a supervisory strategy, but they are reflected on the different sections of the risk matrix and they are part of the institutional profile of the supervised entity.

#### UNITED STATES

Corporate governance is evaluated at every on-site examination. All of the agencies adhere to the guidelines of the Uniform Financial Institution Rating System, commonly known as CAMELS<sup>6</sup>. Among the CAMELS' components, the one on *Management* is the indicator wherein bank supervisors summarize their findings of the effectiveness of bank management and its corporate governance policies and practices. Members of the Board of Directors and senior management are assessed in connection with all the necessary elements to operate the institution in a safe, sound and businesslike manner.

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<sup>6</sup> Ibid.



## CHAPTER 3

# Qualifications of the Members of Banks' Boards of Directors and Their Knowledge of Their Institution's Structure

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The Board of Directors is the unit responsible for providing the organization with a logical structure and solid principles of corporate governance. Therefore, it is important that bank supervisors make a thorough assessment of the composition of the Board of Directors, including the qualifications of each of its members. Supervisors must verify that the Board members have adequate technical abilities and experience, exemplary moral standing and that they pose no conflicts of interest.

### 3.1 OVERVIEW

#### ARGENTINA

During the authorization process, the individuals that will become members of the Board of Directors are analyzed. The supervisory unit evaluates the suitability of each proposed member, taking into consideration his or her professional performance in financial activities, as well as his professional career, whether public or private, in fields similar to the business profile of the entity. In addition, the resumes are analyzed along with criminal and police records, sworn statements and property declarations. Also, corporate policies are also reviewed to determine whether they are consistent with the strategic objectives of the institution and if they are prudent.

#### BRAZIL

During the licensing stage, the members of the Board of Directors are ratified through a technical evaluation.

Through on-site supervision, the following elements are assessed regarding the members of the Board of Directors:

- experience and competence regarding the institution's activities;
- commitment with the institution's objectives;

Also, supervisors must verify that the Board of Directors and senior management have full knowledge of the organization they serve, including its structure, characteristics and the jurisdictions where it operates.

An overview of the processes and practices followed by supervisors in the Region's countries regarding the qualifications demanded of Board members is outlined below.

- understanding of the bank's risk profile;
- independence from senior management;
- interaction with senior management and
- presence of Board members that do not hold executive positions in the institution.

#### CANADA

OSFI's Approvals and Precedents Division evaluates the potential members of a bank's Board of Directors during the licensing process. This unit checks the resumes submitted to verify whether the individuals have a criminal record. Also, meetings are held of the supervisor with the Board of Directors to determine their knowledge regarding the bank's operating structure.

During on-site and off-site supervision, the qualifications and professional and personal abilities of the members of the Board and of senior management are reviewed. Also, a review is made of the bank's internal evaluations regarding the ability of Board members to lead the bank, and the supervisor examines the existence and quality of a self-evaluation program for the Board of Directors.

,In order to determine the Board of Director's knowledge of a bank's operational structure, meetings and interviews are held between supervisors and the Board of Directors. The quality and quantity of information received by the Board of Directors is also evaluated, as well as its role in the approval of policies, internal audits, risk and strategy and business plans.

#### COLOMBIA

The moral and academic status and the experience of Board Members are assessed through the *Comité de Posesiones*. In addition, a supervisor of corporate governance evaluates the composition and functioning of the Board of Directors. This supervisor also analyzes the composition and functioning of the committees that support the Board.

Likewise, during on-site and off-site supervision, the performance of Board Members and their attendance at meetings is reviewed. On some occasions, interviews are held with Board members to discuss in depth specific aspects of the performance of the Board.

#### EL SALVADOR

Members nominated to the Board of Directors must provide a sworn statement in which they state that they meet all the requirements to become a Director. The composition of the Board of Directors is reviewed at least twice a year.

It is worth mentioning that meetings and interviews for coordination are held among supervisors and the Board of Directors, as well as with senior management, to determine their knowledge about the bank's operational structure and to question procedures for identifying and quantifying the risks of the different products and markets with which they deal.

#### NICARAGUA

Members of the Board of Directors are required to deliver updated resumes with the goal of evaluating them.

#### PARAGUAY

Resumes of potential members of the Board of Directors are analyzed to confirm the professional suitability of the nominee.

#### PERU

During the process of licensing, the resumes and property holdings of potential Board members are analyzed. The integrity and relevant experience in activities similar to those that will be performed in the institutions are also assessed.

In addition, every year the Board members and senior officials submit a sworn statement to the Superintendency in which they state they have no legal impediments to performing their duties.

Also, the changes in Directors or senior management of every bank are registered on-line in the Intranet of the Superintendency. A special device is used by off-site analysts to access real-time information about the directors, managers, and main bank officers of a bank. This information is updated *on-line* by the supervised institutions.

Finally, in order to verify the knowledge of Board members regarding the bank's operational structure, periodic meetings are held between the supervisor and the Board Members. Also, there are on-site supervisory guidelines for evaluating the governance bodies, which includes determining whether the Board of Directors complies with the approval and updating the institution's organizational chart, and with approval of the operating manuals.

#### PUERTO RICO

Members of the Board of Directors are required to deliver updated resumes with the objective of evaluating them. Also, an analysis is made regarding the quality of the organizational, jurisdictional, and strategic information that is provided to the Board.

## SPAIN

During the on-site supervision process, an assessment is made of the existence of training plans for the Board of Directors Members, their ability to understand the economic and regulating environment and the self-evaluation process.

It is worth mentioning that there is an Official Registry of High Positions, and inscription in this registry must be authorized or rejected by the supervisory agency. Also, the honorability of the potential member is analyzed, as well as any incompatibility related to leadership positions.

## UNITED STATES

The capabilities of members of the Board of Directors are evaluated frequently by US bank supervisors. Board members are fully evaluated when the institution is first licensed and are again evaluated as to their competence and leadership at every on-site examination. During the initial licensing process, every proposed director must submit a biographic and financial report, which must show all the positions of responsibility that they have held during their careers, including positions in the organization, its holding company or affiliates.

Also, during on-site and off-site supervision the following aspects of board composition and functioning are analyzed:

- the variety of abilities and experience of Board Members;
- balance between independent and non-independent members;
- the time of service of members;
- frequency of Board meetings and attendance of members at board and committee meetings;
- the participation of members of the Board in boards of other organizations;
- depth and quality of Board of Directors' minutes;
- board's responses regarding recommendations issued by the supervision agency and
- the processes for nominating members of the Board of Directors and committees.

Finally, meetings and interviews for coordination are held periodically with the Board of Directors and senior management to ascertain their level of competence, knowledge and involvement.

## 3.2 RECOMMENDED PRACTICES

After analyzing the overview of the Region regarding the supervision of qualifications of members of the Boards of Directors and their knowledge of the operational structure of their respective banking institution, the Working Group subscribes to the following good practices and recommendations:

1. A list should be made of the ideal traits that all members of the Board of Directors must have. The following must be verified: experience and specific knowledge of the banking industry or of the operations that the institution will perform absence of penalties due to deficient management, history of proper handling of credit obligations and lack of a criminal record. The process of authorization must be used to ensure that the minimum requirements for the Directors are met.
2. When assessing the potential members of the Board of Directors, the supervisory agency must keep in mind business plans, financial projections and policies that the banking institution is expected to execute.
3. The suitability and abilities of members of the Board of Directors (as well as majority shareholders, or partners and senior management) must be evaluated by means of frequent meetings and interviews with them. In these meetings, topics of discussion should include the institution's structure, strategic plans and actions for managing risk. In addition, the understanding of these topics by the Board of Directors and senior management should be verified.
4. In evaluations of members of the Board of Directors, the following must be taken into consideration:
  - the time they have served in the Board of Directors ;
  - support committees to which he or she belongs;
  - attendance at meetings;
  - participation in Board's decisions and
  - independence from senior management.
5. Policies adopted by the Board of Directors and the degree of compliance with them must be assessed. For this, the bank should be asked to submit periodically to the supervisor the elements considered by the Board of Directors to approve and monitor policies and the procedures adopted for approving new financial products or growth plans.
6. When evaluating the members of the Board of Directors, the supervisory agency must consider the relationship that each member has with other organizations related to the banking institution (affiliates, *holdings*, etc.) as well as their relationship with other individuals linked to these organizations. This will admit the possibility of evaluating of associated risk and possible conflicts of interest.
7. The Board of Directors must have a considerable percentage of members that are independent from the institution itself, from its shareholders and managers. They must have experience in the industry and knowledge of the bank's different financial products. The percentage must be established according to the specific conditions of each institution.
8. Every banking institution must have a self-assessment of the role and ability of the members in the Board of Directors which may be reviewed and analyzed by the supervisory agency.

9. Supervisory agencies must be empowered to remove any member of the Board of Directors due to noncompliance with legal standards or regulations. Financial penalties must be considered directly applicable to: (i) members of the Board of Directors that do not fulfill their legal and regulatory responsibilities, or (ii) directly to the banking institution for non-compliance with legal standards or regulations. The supervisor must be aware of changes in the Board of Directors and senior management and have the power to veto any appointment that does not comply with established requirements.
10. The supervisor should verify that the Board of Directors has a comprehensive vision of the risks assumed by the institution and that it establishes an appropriate structure of risk management. This is important, among other reasons, because it allows the Board of Directors to comply with its responsibility of determining the capital level for the institution, in accordance with the risk assumed by the institution.
11. The Board of Directors must have an adequate knowledge of the relevant subordinated units of the bank, and this is verified through frequent meetings with the senior management and through internal and external audit reports.

## CHAPTER 4

# Establishment and Communication of and Compliance With Strategic Objectives, Corporate Values, Lines of Responsibility and Accountability

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The Board of Directors is the entity responsible for establishing the institution's general route and for ordering any necessary changes if necessary. Also, the Board of Directors is responsible for implementing policies and corporate values that the institution's employees must follow and for setting lines of responsibility and accountability policies for every unit of the institution.

In fulfilling these responsibilities, it is critical for the Board of Directors to have efficient channels of communication with all of the institution's units, so that the contents of the objectives, policies, values, lines of responsibility and accountability culture will filter

down to the whole organization. Therefore, the Board of Directors must periodically review if the process of communication within the organization is effective.

On the other hand, a crucial element of corporate governance is accountability. An effective process of accountability generates incentives so that every unit and member of the institution, including the Board of Directors, fulfills its objectives.

An overview regarding the way banks communicate its objectives and corporate values to the whole organization is presented below.

## 4.1 OVERVIEW

### ARGENTINA

Supervisory groups review the topics discussed at the Board of Directors' meetings by reading the Board's Minute Book (*Libro de Actas del Directorio*), which contains the objectives, decisions and strategies.

Inspectors in charge of supervision review whether the results of Board meetings are communicated to the rest of the institution through updates or changes in the Organization Manual (*Manual de Organización*) or internal standards, meeting with the staff, etc.

With regard to corporate values, the supervisor reviews whether there is a code of ethics in the organization, and if it is communicated to all members of the institution.

### BRAZIL

The ethical standards and internal controls of corporate values are reviewed on-site. The performance of the Board of Directors in promoting and monitoring these standards is also evaluated.

### BRITISH VIRGIN ISLANDS

The Commission<sup>7</sup> evaluates the way the Board of Directors communicates the bank's objectives and corporate culture through meetings with senior management and through on-site inspections of relevant books and records.

### CANADA

During the licensing process, a discussion is held with the applicant to find out if the Board of Directors will establish an effective communication strategy.

### COLOMBIA

The corporate governance supervisor evaluates of approved and recorded processes that originate from short, medium, and long-term planning. By monitoring these processes, supervisors verify the timely, complete and adequate dissemination of strategic plans designed and approved by the Board.

### EL SALVADOR

The Department of Corporate Governance, as part of its pre-inspection visit, focuses on

<sup>7</sup> Financial Services Commission

learning about the strategic aspects of financial institutions. Later, as part of the information disclosure review process, the Department verifies how these issues are communicated.

#### JAMAICA

The Board of Directors must establish clearly the objectives, strategies, and values that will guide the institution's activities and these should be communicated to the employees. Also, a code of conduct must be established for the institution's employees.

#### PARAGUAY

Supervisors verify whether the annual strategic objectives were approved by the Board of Directors and were communicated to the entire institution.

#### PERU

Guide N° 2, "Strategic Plan and Budget," establishes within its objectives the analysis of the overall process of preparing, executing, evaluating and following up the Strategic Plan, especially as regards the participation of the Board of Directors and senior management. The policy of disclosure and communication of the Strategic Plan within the banking institution is included in this analysis.

Guide N° 30, "Assessment of Consolidated Supervision and Financing to Related Parties," establishes among its objectives the verification of a code of ethics that is disseminated at the level of the consolidated group.

The On-site Guide (SAR), "Organizational Structure," establishes among its objectives the verification of the existence of and compliance with a code of ethics and professional behavior standards applicable to employees in charge of the investment process, as stated in Resolution SBS N° 0114-2005.

#### UNITED STATES

During the applications process, bank supervision agencies require bank applicants to provide information and reports about planned and newly implemented strategic plans, budgets, and other corporate planning processes to help supervision agencies evaluate the board's plans for supervising and communicating the bank's strategic objectives and corporate values. Similarly, bank examiners review the bank's record of adherence to strategic plans, budgets, and policies as well as the means by which the Board and management ensure adherence to these plans and policies at every bank examination.

## 4.2

### RECOMMENDED PRACTICES

The Working Group subscribes to the following good practices and recommendations on the matter of communicating the banking institution's strategic objectives and corporate values to the entire organization.

1. During the authorization process, it is necessary to determine that the institution has a feasibility study and a business plan that establishes the strategic objectives. The institution's objectives must be available to all staff members of the bank (for example, through the *Intranet*).
2. Supervisors should verify that formal mechanisms exist for disclosure throughout the institution of strategic objectives, corporate values, established policies, as well as policies and decisions made by the Board of Directors and/or senior management. This can be done by updating or modifying the organization manual and internal standards, and through meetings with employees.
3. Supervisors should assess whether strategic objectives and corporate values estab-

lished at the parent institution are understood and practiced in the subordinated units. In this regard, supervisors must verify that the Board of Directors has a robust vision of corporate governance and that this framework applies to all the units of an economic group.

- Supervisors must analyze the process for preparing, executing, evaluating, and monitoring the strategic plan, especially in relation to the participation of the Board of Directors and senior management. This recommendation also requires the analysis of the policy for disclosing and communicating the strategic plan or business strategy within the organization.
- It is recommended that a self-evaluation of the Board of Directors be implemented

in connection with its role in communicating strategic objectives, policies and corporate values.

- Supervisors should verify that there is a code of conduct or ethics approved by the Board of Directors, which must include institutional values, standards of conduct for its officials and clear rules regarding possible conflicts of interest and how such conflicts can be prevented and resolved. The code of conduct should be disseminated widely among all staff and employees of the institution.

An overview of the supervision of the implementation and compliance of clear lines of responsibility and accountability in institutions of the Region is presented below.

### 4.3 OVERVIEW

#### ARGENTINA

The supervisory groups evaluate whether the actions of the Board of Directors are appropriate for complying with their duties and responsibilities. In addition, an evaluation is made of the effectiveness of the organizational structure by analyzing the Organizational Chart, the Organization Manual and the responsibilities assigned to each of the executive positions.

#### BRAZIL

During the licensing process, the business plan is evaluated which, among other items, must contain a clear definition of the responsibilities assigned to the different levels of the institution.

The following issues are evaluated during the on-site supervision:

- the existence of documents that establish the levels of authority and communication required;
- the existence of clearly established lines of responsibility, accountability, and limits of authority of managers and staff members;
- whether conflicts of interest exist in the business activities of the group;
- influence of non-financial companies over the financial companies of a group.
- positions occupied by members of senior management in other companies.

#### BRITISH VIRGIN ISLANDS

At the licensing stage, applicants must submit a business plan that details the strategic objec-

tives and organization chart and which defines clearly lines of responsibility and reporting.

During the on-site inspection, an assessment is made of the adequacy of risk management and control systems in order to ensure the effectiveness of the Board of Directors in enforcing lines of responsibility and accountability.

Finally, the Commission holds periodic meetings with senior management to ensure that the lines of responsibility and accountability were established in the reviewed and approved business plan are implemented and put into practice.

#### CANADA

Discussions are held with applicant during the licensing process in order to find out if the Board of Directors will establish clear lines of responsibility throughout the organization.

#### COLOMBIA

In supervision visits, a detailed examination is made of how the Board of Directors controls management. Specifically, the examination reviews the mechanisms established by the Board—such as reports, indicators and budget compliance—to evaluate the results of each manager.

For the annual stockholders meeting, the Boards of Directors of the supervised institutions must submit a management report that is used as a tool for reviewing accountability.

#### EL SALVADOR

Through review of the Operating Plan, an assessment is made of the establishment of clear goals and adherence to lines of responsibility. This review must include quantifiable goals for business units, including subsidiaries, as well as a timeline and the designation of the person responsible for projects. The monitoring of the degree of completion with goals and projects should be stated in the minutes of the Board of Directors or of one of its committees.

It is also required that the unit that reports on the monitoring of financial goals and the progress of projects be independent from the individuals assigned to those tasks, in order to avoid a bias in the information reported.

#### JAMAICA

At the licensing stage, the assessment to verify if clear lines of responsibility have been established in the institution is done through reviewing proposed organization charts and department structures to ensure proper lines of reporting. The roles and responsibilities proposed for each staff member of the organization are also reviewed.

In the on-site supervision, the assessment verifies if there are clear lines of responsibility and reviews the following items:

- discussions with senior management regarding their roles and responsibilities;
- contracts for activities assigned to third parties (outsourcing);
- changes in organizational structures;
- internal and external audit reports and
- reports from the head office or subsidiary units.

#### PARAGUAY

A formal analysis is made of the *Manual of Duties* and it is reviewed if the Board of Directors established annual strategic plans and policies. It is also determined whether the governance structure at the corporate level will contribute to a proper line of supervision.

#### PERU

During inspection visits to an institution, supervisors use verification procedures, such as reading the minutes of meetings of the General Meeting of Shareholders, Board of Directors and committees (audit, risk, others). Also, verification of an appropriate separation

of duties is part of the on-site supervision process as it relates to all the main risks (credit, market, liquidity, and operational).

As part of the evaluation of corporate governance, the Rating Methodology (*Metodología de Clasificación*) requires review of the “Regime of Duties and Responsibilities.” The degree of authority of the Board of Directors is analyzed to define its responsibilities and those of the management staff, and whether management is responsible for delegating tasks and establishing an administrative structure adequate for the complexity of the business.

#### PUERTO RICO

One of the methods for evaluating the performance of the Board of Directors is through reviewing the minutes of their meetings. Through this review, it is possible to identify the process of decision-making, supervision of management, the information that reaches the Board and how decisions are made based on the information provided. The supervisor also evaluates how directives flow through the different components of the institution (subsidiaries, departments, etc.).

Another primary source of information is reports from internal audit. These reports present the evaluation of and compliance with internal controls. The response of management and its commitment to correct and improve

the operational processes implemented by the Board are evaluated.

#### UNITED STATES

In an effort to understand the Board of Directors’ task in establishing clear lines of responsibility and accountability, during the licensing process bank supervisory agencies ask applicants for their organizational charts, business plans, policies, and the procedures they propose. This type of evaluation continues after the bank is licensed, and is conducted on every on-site examination.

During the initial licensing process and at every on-site examination, banking supervisory agencies assess the role that the Board of Directors has played in establishing and enforcing lines of responsibility and accountability as follows:

- discussions with the directors, senior management, risk managers and auditors;
- findings from internal and external audits;
- degree of deficiencies in internal control;
- interaction between the director and risk managers and
- accountability regarding risk control by business lines managers.

## 4.4

### RECOMMENDED PRACTICES

The Working Group endorses the following good practices and recommendations on the issue of implementation of and compliance with clear lines of responsibility and accountability in the institution.

1. The supervisor must verify that the Board of Directors has established clear lines of

responsibility and accountability in the supervised institution and its affiliates and subsidiaries in cases where the institution is part of a group.

2. During the licensing process, authorization must be denied if the property structure of the group is so confusing that it would be

difficult to supervise or when the property structure fails to provide certainty to the supervisor regarding how and by whos the lines of responsibility will be established. It must be borne in mind always that every entity is responsible for its own corporate governance before its depositors and other interested parties, including the supervisor.

3. In on-site and off-site supervision processes, the performance of the Board of Directors must be evaluated through reviewing the minutes of its meetings and working documents of the control bodies and through interviews with directors and senior management. It is necessary to review whether the Board of Directors has established clear and proper lines of responsibility and accountability mechanisms in all levels of the organization. Similarly, review must verify whether the Board monitors adherence to those lines and if it takes or orders corrective measures required in each case.
4. The different goals for each time period must be clearly established for different area or units. Also, the periodic reports of management must be reviewed to verify that these goals were achieved and if not, to find out the reasons for non-compliance. That is, accountability must be practiced. In this regard, it is necessary to review the methodology of the institution for monitoring the individuals responsible for executing and complying with the approved plans.
5. Supervisors must review whether the Board of Directors of the home office communicates the strategic guidelines to the different subsidiaries and whether it monitors compliance with its directives without minimizing the responsibility conferred on each entity for its own governance.
6. Supervisors should conduct interviews with officers or employees of differing hierarchical levels of the institution to determine their perceptions of the monitoring by the Board of Directors of their work.
7. It is recommended that the Board of Directors implement a methodology for self-evaluation to assess its own role in establishing and enforcing lines of responsibility and accountability mechanisms in the institution.
8. If, as a result of inadequate oversight by the Board or deficient control by management, the entity is exposed to risks that may compromise its soundness or the security of its depositors or creditors, the supervisor must impose penalties, order the removal of the directors, suspend operations of the institution and even cancel the authorizations granted.



## CHAPTER 5

# Verification of the Performance of Senior Management and Their Compliance With Policies Set by the Board of Directors

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Adequate work by the Board of Directors in setting objectives, policies, practices and actions has no value if senior management does not carry out these directives. Therefore, the supervisor must continually review the effectiveness of the transmission channel between the Board of Directors and senior management, and make sure that managers fulfill or

strive to comply with the mandates and resolutions of the Board of Directors.

In the next section, an overview is presented of the supervisors' reviews of how the Board of Directors verifies that senior management executes the policies and decisions established by the Board

## 5.1 OVERVIEW

### ARGENTINA

The supervisor analyzes the functioning of the committees that review compliance with strategic objectives. For this, the work of the Audit Committee is critical, since it must report to the Board of Directors about how well management is applying the established policies, reviewing that the business strategies and exposures to risk respect the established parameters. Supervision groups read the minutes released by the different committees and analyze the way the identified observations are treated and how they are communicated to the Board of Directors.

### BRAZIL

Through on-site supervision, the following are assessed:

- the role of the Board in monitoring senior management;
- potential problems in delegating activities;
- decisions made by the wrong staff persons and
- the ability of senior management to monitor properly all activities in their business areas and control key individuals.

### BRITISH VIRGIN ISLANDS

During the licensing stage, the applicant is

required to submit a business plan that defines lines of responsibility and the policy for reporting, including the monitoring responsibilities of senior management. In the on-site and off-site supervisions, interviews are held with senior management and relevant books and records are reviewed to verify the assignment of responsibilities, reporting and monitoring.

### CANADA

During the licensing stage, OSFI evaluates the Board of Directors and the committees to ensure that the proper supervisory functions have been established. OSFI's *Board Assessment Criteria* expects the Board to appoint the CEO, establish the term of his or her mandate, monitor the CEO's performance and approves the CEO salary, as well as the salaries of other top-ranking executives.

### COLOMBIA

The supervisor of corporate governance, as part of the management control assessment, checks the type of reports received by the Board of Directors from senior management. In addition, management indicators and their correspondence with planned objectives are also verified.

### JAMAICA

During the on-site supervision, an assessment is made of the monitoring of activities

by senior management, as well as how they have adhered to their role and duties. This is done principally by examining the minutes of the meetings held by the Board and senior management, as well as the reports prepared by the senior management for the Board.

#### PERU

The supervisor evaluates the degree to which the management function has established an adequate system of internal control in compliance with the guidelines issued by the Board of Directors. The key decisions are adopted by more than one person (dual control), avoiding situations in which managers:

- become involved in business decisions that do not correspond to their duties;
- take over responsibilities from an area for which they do not have the required abilities and knowledge;
- are incapable of exercising control and of questioning themselves about the activities of supposedly “star” employees (staff who originate profits quite higher than rational expectations).

#### SPAIN

Through reading the minutes and documents submitted by the governance bodies of the in-

stitutions, and by holding interviews continually with the principal executives, the inspection teams acquire specific knowledge of the controls that were established by the Boards of Directors.

#### UNITED STATES

The effectiveness of the relationship that exists between the Board of Directors and executive management is evaluated as part of the examination process. Examination procedures have been designed to test whether appropriate channels of communication exist between the Board and management. Transactional testing is conducted to evaluate the degree of compliance with policies and standards established by the Board.

The inspectors review the minutes of the Board of Directors and its committees, which are expected to reflect the discussions by Board members and the approval of any strategic change or important operations. They also check the reports submitted by senior management, which are designed to inform the bank directors about the condition of the bank and the compliance status of the objectives and policies established by the Board of Directors.

Supervisory agencies expect senior management to get approval from the Board before implementing new policies or new activities

## 5.2

### RECOMMENDED PRACTICES

With regard to verification of the performance of senior managers and their execution of policies established by the Board of Directors, the Working Group endorses the following good practices and recommendations.

1. In the licensing process, it must be verified that the by-laws of the institution to be constituted establish that the Board of

Directors will monitor the performance of senior management.

2. The by-laws must set out the obligation of senior management to be accountable to the Board of Directors regarding compliance with policies and instructions established by the Board and implementing the strategic plan and budget.

3. The qualifications of individuals who hold senior management positions must be reviewed to verify their professional and moral suitability and experience. In addition, it is necessary to confirm the existence of objective processes for selecting senior management and all employees at all levels of the institution.
4. The functioning of management information systems and the Board's minutes should be reviewed to ensure that the Board receives accurate and timely information and that its deliberations and decisions are well documented.
5. The supervisor must evaluate the follow-up methods used by the Board of Directors to verify the implementation of its decisions and the protocol followed in case of noncompliance or faulty execution.
6. Interviews must be held with senior management at the banking institutions in order to obtain first-hand knowledge about how the Board's decisions have been executed.
7. The supervisor must verify that the Board of Directors has the power to remove a senior management official when, based on a detailed evaluation, it is determined that: his or her performance is not adequate to comply with the objectives and assigned tasks; when he or she has failed to implement policies established by the Board or the strategic plan; when personal circumstances or property holdings may cause conflict of interest in fulfilling his or her duties or when the manager does not comply with the code of ethics or standard of conduct.

# CHAPTER 6

## Promotion of Sound Internal Controls and of External Audits

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The Board of Directors and senior management are responsible for ensuring that sound controls are established in all areas of the institution to guarantee its proper functioning. Auditing contributes to this by complementing those controls and by reporting to the Board when there are deficiencies or other failures in the institution.

Effective auditing requires that Board of Directors take the necessary positions to guarantee the quality and independence of the

audit reports. Such active involvement of the Board poses diverse challenges, including the necessity that Board members have adequate technical preparation for analyzing audit reports and have enough time available to make a comprehensive review of these matters.

An overview of the supervisory practices regarding implementation of sound internal controls and the effectiveness of auditing is presented below.

## 6.1 OVERVIEW

### ARGENTINA

Under the current structure, the review of internal and external audits of financial organizations is conducted by the Office of Auditor Control (*Gerencia de Control de Auditores*), which is in charge of verifying that minimal auditing procedures stipulated in the law are applied. The Office also certifies the performance of professionals involved and the work of the Audit Committee.

The observations made by this Office, as well as the grade that is assigned to the internal and external auditing functions, are communicated to the *Supervision Area*, and form part of the initial evaluation that is used to define the inspection strategy and to plan the supervision procedures. The observations and grades are taken into account for the subsequent overall rating of internal control and of the management of the institution.

### BRAZIL

During the licensing process, through an assessment of the business plan and other documents, supervisors review the proposed framework for internal control and the mechanisms that will ensure an effective use by the

Board of Directors and senior management of the work entailed in the internal and external audit. These items are also supervised on-site, and the effectiveness of the internal audit is also reviewed.

The Central Bank must be notified as to who will be members of the Audit Committee or the person who will be in charge of audit matters and shall be advised of the removal of any member of the committee. Also, the Central Bank will be informed of the hiring or firing of an external auditor, as well as the reasons for his or her removal.

The Central Bank must have access at all times to information regarding the external auditor's opinion about the evaluation of the internal control system, noncompliance with laws and regulations and the responsibilities of the audit committee.

### BRITISH VIRGIN ISLANDS

In the licensing stage, the applying institution must identify an external audit firm, which must be approved by the Commission. During the on-site inspections, the effectiveness of internal and external audits is reviewed.

#### CANADA

During the licensing stage, a review is made to make sure that all control mechanisms are in accordance with best practices. OSFI confirms that applicant will create an audit committee and will confirm the name of the external audit firm.

OSFI also regularly evaluates the performance of risk control, including the quality and quantity of the information that the Board of Directors receives. In addition, the supervisor reviews the minutes of the meetings held by the Board of Directors to check the documents they used to make their decisions.

#### COLOMBIA

SFC is empowered to authorize external auditors. During the licensing process, SFC verifies the composition of the audit committee, the creation of an internal control area in the institution, its location in the organization chart and whether available resources guarantee its proper functioning.

The corporate governance supervisor reviews the presentation of reports from the internal control area and from the external auditor to the Audit Committee and the Board of Directors. In addition, the supervisor verifies the adoption of measures by the Committee or the Board of Directors when necessary, and the follow-up of implementation. Also, he analyzes the internal control structure and the adequacy of resources in relation to the dimension of its responsibilities.

It is worth mentioning that the corporate governance supervisor makes periodic reviews of the proper composition of the external audit body and other special bodies for internal control.

#### EL SALVADOR

During the on-site supervisory process:

- an assessment is performed of the professional experience and academic prepa-

ration of the external auditor as well as the training provided by the bank to that auditor.

- a study is made of the organizational positioning of the internal audit function, which should be accountable to the Board of Directors.
- the existence of an audit committee is verified, making sure that it includes 2 or 3 members of the Board of Directors who do not hold salaried positions in the institution.
- the work plan for auditing is analyzed, verifying that the plan covers considered critical owing to their risk and evaluating the degree of compliance.
- an analysis is made of the scope of reviews and follow-up carried out by supervised units as regards the implementation of corrective measures based on remarks of the internal audit.
- an assessment is made that a work plan exists for the internal and external audits and it is followed.

#### JAMAICA

In the licensing stage, the supervisor evaluates the adequacy of internal control systems and the management of proposed risks. During the on-site inspection stage, the supervisor assesses the degree to which internal control systems achieve the following:

- ensure the efficient and effective use of resources are used efficiently and effectively to protect the institution against financial loss;
- ensure that financial information is timely, relevant, reliable and complete and
- facilitate compliance with the requirements of by-laws and regulations.

## PARAGUAY

The supervisor conducts a review of controls established for the most important areas and they verifies whether the internal audit function is organically linked to and reports directly to the organization's Board of Directors. An additional review verifies whether the internal audit, for the performance of its functions, is provided support from the *General Management* and the rest of the institution's areas.

Supervisors corroborate whether the external audit meet the criteria of independence and of employee rotation as defined in the manuals.

## PERU

Before granting a license, the organization must have created an Internal Audit Unit that reports to the Board of Directors and must have implemented an internal control system that corresponds to the complexity of the operations that will be performed.

The objectives of the On-site Supervisory Guide No. 29, "Internal Control System and Internal Audit," are to:

- verify that the Board of Directors, the audit committee, and management have participated in designing and implementing the internal control system;
- evaluate the independence and adequacy of resources of the *Internal Audit Unit*;
- assess the scope of audit reports and
- assess compliance with recommendations issued by the *Internal Audit Unit*, *External Audit Unit* and *Bank Supervisor*.

## PUERTO RICO

The supervisor determines the effectiveness of the internal controls implemented by the Board of Directors by analyzing the Board meeting minutes and the internal audit reports. Through the remarks included in

the internal audit reports, the soundness or weakness of the internal controls is determined. Through the Board's minutes, the supervisor assesses the decisions taken by the Board and the measures taken to strengthen the controls.

Also, the internal audit department is evaluated to establish its efficiency. This is done by reviewing its auditing program to determine its scope and whether it is appropriate for the size, complexity and risk profile of the organization.

## SPAIN

Special emphasis is placed on the evaluation and adaptation of the internal control of the financial entities, verifying that the structure for delegating responsibilities is proper, and that external and internal auditors enjoy adequate independence as well as sufficient resources for them.

For this purpose, supervisors have access to the minutes of the Audit and Compliance Commission (and to the documents used at the meetings) and, in general, to all documents of the Board of Directors, as well as to the reports and working papers of all internal audits made by the entities. The information included in both internal and external audits is checked to review that it corresponds to that obtained by *Banco de España* in on-site and off-site supervisions.

It is worth mentioning that twice a year a meeting is held with the individual responsible for internal audit to check the annual work plan and to comment on its development.

## UNITED STATES

In the licensing stage, bank supervision agencies require applicants to explain how the institution will keep sound internal control systems and independent internal and external audits.

In the on-site supervisory stage, supervision agencies assess how the Board of Directors and

senior management preserve sound internal controls and foster effective auditing through:

- discussing with the Board of Directors, senior management and audit team how to communicate to the rest of the organization the importance of strong internal controls;
- reviewing the qualifications and independence of the internal auditor and his or her team;
- reviewing the appropriateness of the coverage, frequency and procedures of the audit;

- checking the recommendations and conclusions of audit reports;
- determining the response time of the Board of Directors and senior management to the auditor's recommendations;
- holding meetings with the audit committee and reviewing the experience of its members and
- reviewing the corporate culture in general as regards auditing.

## 6.2 RECOMMENDED PRACTICES

For the Board of Directors and senior management to maintain robust internal controls and promote effective audits, the Working Group Task subscribes to the following best practices and recommendations.

1. During the licensing stage, an analysis must be made of the structure of internal controls and the position that internal audit will have in the institution's hierarchy. Statutory clauses must be included that assign the Board of Directors the responsibility for assessing and monitoring audits and internal control functions.
2. Also during the licensing stage, it is necessary to evaluate the quality of human resources and the availability of material resources for these structures, as well as the flow of information to them.
3. The Board of Directors and senior management must utilize effectively the information produced by the internal audit, by managers responsible for internal control and by the external audit. This allows for
- an independent verification, contributing to the quality of information provided by operational areas, and in turn strengthens corporate governance at financial institutions.
4. It is necessary to have an audit committee with an adequate percentage of members that are independent from the organization's management. The committee members must have clear attributions for evaluating the effectiveness of audits and the quality of accounting and management information.
5. Supervisors should verify that the internal auditor does not perform other duties within the organization and that in no case does he or she intervene in or authorize the operations that will be audited. It is necessary to promote a structure in which the internal auditor reports to the auditing committee and not to management, in order to achieve independence between the audited management and the auditor. In similar fashion, the internal audit function

- must be independent from the principal managers of internal control functions.
6. It is necessary to review that the Board of Directors and senior management are committed to a strong control culture.
  7. The auditing committee should be assigned the task of reviewing the resumes of the external auditors. This committee, and not senior management, must be the one to select the resumes to be presented to the shareholders' meeting or to the body in charge of appointing the external auditor.
  8. Institutions should hire qualified external auditors who perform their work with due professional zeal, in accordance with standards of the profession standards and with a work scheme that guarantees the quality of the accounting information. It is necessary to verify that the external auditor does not perform other activities in the organization in addition to the external audit.
  9. If the external auditor is an individual, there must be turnover of that person at least every five years. In the case of an audit firm, the contract must contain clauses that commit the firm to rotate individuals that perform the audit, and ensure that the person who is rotated out in compliance with this clause can only audit the same company again after two years have elapsed.
  10. Incentives must be put in place to stimulate the updating of technical capacities of internal auditors and of the individuals responsible for the institution's internal controls.
  11. In case a banking institution entrusts the internal audit to a third party, arrangements must be made such that an individual within the organization serves as the liaison between the financial institution and the firm that provides the service. This liaison person must establish requirements considered necessary to best fulfill this function and approve the audit plan. It must be prohibited that the firm providing external audit services to the institution be the same firm or be linked (for example, through same shareholders) to the firm that will conduct the internal audit.

## CHAPTER 7

# Role of the Board of Directors in Setting Compensation Policy Consistent With the Bank's Corporate Culture, Strategy and Long - Term Objectives

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The compensation policy of a banking institution is an important element of corporate governance since it has a significant impact on the incentives for staff members. A compensation policy that excessively rewards the short term and immediate profits could exacerbate the risks assumed by an institution.

At the licensing stage, the supervisor must verify that the entity plans to issue a com-

ensation policy decided on by the Board of Directors and will disclose it to the various interested parties.

An overview of how supervisors verify that Board of Directors establishes a compensation policy consistent with corporate culture, strategy and objectives of the bank is presented below.

## 7.1 OVERVIEW

### ARGENTINA

During the on-site supervision, an analysis is conducted of compensation policies and the incentive structure (bonuses for senior management and staff).

### BRAZIL

During the licensing stage, a review is made of the details of financial incentives and the compensation policy.

During the on-site supervision, the following are reviewed:

- the existence of programs that define compensation and promotion based on merit;
- that remuneration and bonus payments are evaluated compared to the current market rates;
- whether payment practices in place increase the probability of conflict between individuals' objectives and those of the institution, especially regarding risk and compliance and
- that policies exist related to financial incentives for senior management and other key positions that are approved by the Board of Directors and are consistent with ethical values, objectives, strategies and the control environment.

### BRITISH VIRGIN ISLANDS

The Committee holds meetings with the Board of Directors and/or senior management to ensure that compensation policies are appropriate.

### CANADA

During the licensing process, compensation policies are reviewed in order to make sure they are sound and prudent. OSFI expects the Board of Directors to appoint the Chief Executive Officer (CEO) and other important positions of senior management and to establish their mandates and appropriate compensation.

### COLOMBIA

SFC does not usually monitor the Board of Director's activities regarding compensation policies. The corporate governance supervisor learns the payment schedule at supervised organizations through periodic surveys.

In addition, the minutes of meetings where Board members are appointed are submitted to SFC and include the remuneration for these members.

### JAMAICA

During the licensing stage, the supervisor evaluates the degree to which the Board of Directors ensures that compensation policies are consistent with corporate culture and proposed strategy, long-term objectives and the control environment.

The on-site supervision includes an assessment of the deliberations and actions taken by the compensation committee. The institution is required to disclose all the components of compensation of senior managers.

#### PARAGUAY

A very general review is made of the scheme of salary and economic incentives established to pay and create incentives for staff members and managers to see if it is effective for the performance of their tasks in accordance with the policies and strategic objectives of the entity.

#### PERU

As part of the “Internal Ranking of Companies in the Financial System”, within the indicator for “Suitability of Management and Corporate Governance”, the compensation system is assessed to see if it is designed to increase long term corporate value, avoiding incentives that lead to excessive risk taking. In this regard, the on-site supervision evaluates the policies and practices of compensation for Directors, management and key personnel in order to find out if these are adequate and consistent with the organization’s objectives, strategies, control environment and ethical values and that they do not depend excessively on short-term performance. The evaluation assigns a rank between 1 (best international practice) and 5 (non-existent practices).

#### SPAIN

As part of the control system, the internal governance of an institution must directly manage the compensation policy. Therefore, the supervisor:

- determines how the compensation policy is established and who makes the decisions regarding the policy;
- evaluates the compensation policy of directors and the transparency of their retributions;
- assesses the existence or lack of a committee in charge of the firm’s compensation

policy and verifies the independence of its members and

- studies the compensation policy, including contributions to pension funds, payments in kind, soft loans, etc.

#### UNITED STATES

During the licensing process, bank supervisors require that each applicant, pursuant to the Interagency Charter and Federal Deposit Insurance Application, discuss the proposed terms of employment, including compensation and benefits, and attach a copy of all pertinent documents, including an employment contract or compensation arrangement.

Furthermore, during on-site examinations, bank examiners review compensation practices to detect inappropriate incentives or excessive compensation. The *Interagency Safety and Soundness and Compliance Procedures* consider that compensation is excessive when *amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal shareholder.*

In order to evaluate the Board’s oversight of compensation, the examiners:

- review written materials and disclosures related to the compensation program and determine whether disclosures clarify or obscure the total amount of compensation paid and the basis for that payment;
- determine if there is a separate compensation committee, if it is independent and if the CEO does not have undue influence on it;
- determine components of executive compensation (salary, annual bonus, long-term incentive compensation, perquisites, etc.);
- determine whether compensation creates a financial incentive to take on or hide excessive risk or circumvent accounting rules and

- determine whether the internal audit assesses executive compensation strategies and methodologies.

## 7.2

### RECOMMENDED PRACTICES

Regarding the supervision of the Board of Directors' role in establishing compensation policies consistent with the bank's corporate culture, strategies, and objectives, the Working Group subscribes to the following good practices and recommendations.

1. The institution's by-laws must establish that the Board of Directors, through a Compensation Committee, will be in charge of setting compensation policies for senior management. The members of this committee must be independent, not be influenced by the CEO of the bank and should have relevant experience.
2. The compensation policy must be clearly established and specify the components of compensation for executives. The criteria for assigning compensation must be linked to the level of responsibility.
3. The criteria for variable remuneration, should it exist, must be clearly stated, and for the cases when additional benefits will be granted, such as assuming the employee's personal and family expenses.
4. Special attention must be given to ensure that compensation policies do not establish inappropriate incentives that drive senior management to take excessive risks or evade accounting rules.
5. Supervision must see that performance objectives are established for executives, analyze the adequacy of these objectives and evaluate the metrics used to measure the objectives.
6. Supervisors must review whether the internal audit evaluates the strategies and methods of executive compensation.
7. Supervisors must review whether clear rules are in place for remuneration with shares and it must be clear whether there are retention requirements with respect to these shares.
8. Supervisors should verify that controls are applied to representation and/or public relations expenses which Board Members and senior management are allowed to access.
9. The supervisor must verify if the compensation policy at subsidiary units is duly monitored by control bodies at headquarters. If there is a compensation committee at the local subsidiary, its independence as well as its technical abilities to exercise its duties should be verified.
10. Supervisors should review whether compensations at the subsidiaries are reasonable compared to those of other financial institutions with similar size and risk profile in the same jurisdiction.
11. Finally, mechanisms must be established for disclosing the institution's compensation policies to interested parties.

# CHAPTER 8

## Transparent Management of Banking Institutions

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The last chapter will discuss the supervision of transparency, a pillar of corporate governance. Transparency requires that banking institutions provide relevant information on a timely basis to the various stakeholders so they can make informed economic decisions. The requirement of transparency in banking institutions establishes incentives for managers to carry out actions clearly aimed at achieving the objectives of the institution and not those which benefit themselves personally.

During the licensing process, the supervisor must verify that the institution will have the

appropriate means to report relevant information to the market and stakeholders about the objectives, mission and vision of the institution, its by-laws, the composition of governance and control bodies, its policies for selecting staff and compensation for employees, code of ethics and financial information, among other items.

An overview of how transparency is supervised at the banking institutions of the Region is presented below.

## 8.1 OVERVIEW

### ARGENTINA

The supervisor controls the presentations made in compliance with the *Internal Requirements of Transparency and Institutional Information of Financial Organizations*. This analysis is complemented with the reading of the *Social By-laws (Estatuto Social)* and subsequent modifications, verification of the property structure, shareholder participation and the composition of the Board of Directors. In addition, the supervisor requests an updated organization chart to assess whether it includes the main business areas and the structure of affiliates and branches.

### BRAZIL

The following issues are reviewed during on-site supervision:

- accurate and timely disclosure of issues related to the institution, including its financial status, performance, controls and corporate governance;
- role of the Board of Directors and senior management in ensuring transparency, strengthening corporate governance prac-

tices and in providing sufficient information to stakeholders and the general public;

- provision of information regarding ownership and control structures;
- relationship of the Board of Directors with supervisors and other regulatory entities and
- reports required by the Central Bank.

### BRITISH VIRGIN ISLANDS

The supervisor requires institutions to disclose policies and procedures relevant to the clients and staff of the institution. During the on-site inspection, the Commission makes sure that appropriate systems are in place for disclosing relevant information to staff and other stakeholders.

Institutions are also required to publish annual audited financial statements and to send periodic reports to the Commission, which may be focused on a particular area relevant for the Commission.

#### CANADA

During the licensing stage, the applicant is expected to provide the information considered necessary, including the structure of the group, so that the supervisor can determine how easy it is to supervise an institution. Corporate governance documents that can be found on the bank's internet page are also supervised.

#### COLOMBIA

During the licensing stage, the supervisor evaluates the organizational structure, government bodies, voluntary self-regulation codes and other matters. During inspection visits, the corporate governance supervisor reviews the capital structure in order to establish its transparency.

The conglomerate supervisor determines the real beneficiaries of the subsidiaries that make up a conglomerate, and their participation in affiliates, with the purpose of establishing whether there are relationships of subordination.

#### EL SALVADOR

The transparency of operations and of the administration of the Board of Directors and senior management at banking institutions are evaluated through interviews and on-site inspections.

The supervisor verifies that communications to stockholders and stakeholders include information about the composition of the Board of Directors and of the ownership structure, policies related to conflict of interest, size of transactions with related entities, etc.

In addition, the supervisor verifies that the structure of the Board of Directors is disclosed in the annual report of the bank (*Memoria de Labores*).

#### JAMAICA

At the licensing stage, the applicant is required to send relevant information to assess the degree to which the proposed institution will be governed in a transparent way. These

documents include organization charts, shareholder structure, policies and procedures to be implemented and a risk management scheme.

During the on-site supervision, different aspects of the financial reports are reviewed to establish if they accurately reflect the financial soundness of an entity. The timeliness and reliability of the information disclosed is checked to see if it allows for evaluating the bank's financial position, its performance, risk profile and management practices.

During the off-site supervision, the corporate governance framework is monitored, including the composition of the Board of Directors, the subcommittees, management structure, etc. In addition, financial and non-financial disclosures that were published in audited financial reports are checked, as well as other announcements or public disclosures made by the institution.

#### PERU

The balance sheet and the consolidated profit and loss statement of the conglomerate are published every year in the Official Gazette (*Diario Oficial*) and in a widely circulated local newspaper within seven working days after they were submitted to the Superintendency. These financial statements must be audited.

In addition, supervised companies are required to publish quarterly their financial statements and information about their leverage ratio (sufficiency of regulatory capital). Monthly financial statements and the principal indicators of supervised institutions may be seen on the Superintendency's web page. In addition, information about the director, general manager, telephone and address of supervised organizations can be found on this web page (directory of the firm).

#### SPAIN

The supervisor analyzes the information pub-

lished by the institutions, complementary to the accounting information, in order to establish the degree of transparency in relation to shareholders, investors, financial analysts and the remaining stakeholders. For this purpose, the supervisor reviews published information, especially the institution's web page, analyzing its precision and adequacy.

The *Commission of European Communities* (2005/162CE) makes the following recommendations regarding transparency and communication.

- The Board of Directors must disclose at least once a year adequate information about its internal organization and about the procedures applicable to its activities, indicating, in particular, to what degree the self-evaluation procedures have led to important changes.
- Also, the Board of Directors must guarantee that shareholders are duly informed about the firm's businesses, its strategic focus and

<sup>8</sup> *Financial Services Commission*

## 8.2 RECOMMENDED PRACTICES

Regarding transparent management of banking institutions, the Working Group endorses the following good practices and recommendations.

1. Supervision authorities must progress towards a more active promotion of public disclosure, either by legal requirements or by issuing standards for disclosure. It is important that transparency exist in areas of the institution which are not mentioned in the disclosure requirements of stock markets or accounting reports.

the way that risks and conflicts of interest are handled. The role of managers regarding communication and commitment to shareholders must be clearly described.

### UNITED STATES

In accordance with supervisory strategies based on risks, banking supervision agencies make an annual on-site inspection to check transparency examining the following issues:

- timeliness and accuracy of financial disclosures;
- the accuracy of required reports;
- the quality of the information available in the network (corporate governance standards, committees and their members, codes of ethics and standards of conduct, financial reports, reports to SEC,<sup>8</sup> etc.) and
- the relationship between the Board of Directors and shareholders.

2. At the licensing stage, the supervisor must check that the institution has in place mechanisms for disclosing information, or intends to create them (for example, a web page) in the near future. Also, the supervisor must check that the institution plans to establish an information disclosure policy.
3. At later supervisory stages, the institution's web page must be reviewed to verify that it contains the following information:
  - Structure of the Board of Directors – including the size, name of the members, selection process, qualifications, directo-

- ries, criteria of independence, participation in committees, etc.;
- Ownership structure – including information about the principle shareholders, rules for voting rights, majority participation of shareholders in the Board of Directors or in senior management positions;
  - Organizational structure – including information about the structure of the group of which the banking institution is a part, the bank’s organizational structure, senior management structure, lines of business, Board of Directors and management committees;
  - Incentives structure – including information about remuneration policies, compensation packages for executives, stock options, etc.;
- Code of ethics / conduct of business – including the code or standard of conduct, including details about any self-evaluation performed by the Board related to these codes or policies and
  - Exposure to related or linked parties – including information about policies related to conflicts of interest as well as the nature and scope of transactions with affiliates and related parties.
4. The contribution of self-evaluations to transparency must be emphasized. The supervisor can demand that every bank disclose a self-evaluation regarding compliance with corporate governance.
  5. The level of transparency at subsidiaries must be assessed and corrections must be applied if needed.



## | FINAL WORDS |

In this document, the Working Group presented an overview of the Region as regards six critical corporate governance issues based on the eight Principles of Corporate Governance established by Basel Committee. The overview makes it possible to deduce that ASBA Members are very much aware of the importance of maintaining the trust of all stakeholders of the banking institution, and the important role that a sound and reliable corporate governance framework plays in preserving this trust. This survey shows that ASBA Members are working, through different strategies and practices, to strengthen their corporate governance supervision framework, which conveys encouraging prospects for the importance and attention that corporate governance is given and will be given among the banking institutions of the Region.

In this document, the Working Group presented fifty nine good practices and recommendations. It is important to clarify that the Group did not intend to create an exhaustive list of recommendations or a recipe that must be applied precisely without evaluating the costs and obstacles to its implementation.

In this regard, and taking into consideration the heterogeneity in the stage of development of the corporate governance frameworks among the different Associated Members of ASBA, this paper aspires to be a guide of support and a compendium of elements and good practices that can be taken into consideration by Associated Members who want to fine-tune their corporate governance supervision guidelines or wish to promote changes in pertinent regulations and laws.

## **MISSION**

To develop, disseminate, and promote banking supervisory practices throughout the Americas in line with international standards. To support the development of banking supervision expertise and resources in the Americas, through the effective provision of training and technical cooperation services.

## **INSTITUTIONAL OBJECTIVES**

The Association of Supervisors of Banks of the Americas is formed by the entities in charge of banking supervision in each of the countries of the American continent and Spain. Its main objectives are:

- Promote and maintain close communication among the Association's Members, in order to facilitate co-operation among them, and to promote the improvement of their respective capabilities;
- Provide its members with a high-level discussion forum for the exchange of information, ideas, techniques, experiences and knowledge over their scope of competence ;
- Promote research as well as systematic and permanent training programs, with the purpose of establishing training standards in the region and providing technical co-operation services among its Members;
- Promote co-operation and exchange relationships with non-member bank supervisors, with similar associations as well as with international and multilateral institutions, engaged in activities similar to those of the Association; and
- Perform any general activity related to its purposes.