Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System

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Best Practice in Corporate Governance in Australian Financial Institutions

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INTRODUCTION

This short paper provides an overview of best practice in corporate governance in major financial institutions in Australia.

The four major banking groups in Australia (viz ANZ Banking Group Ltd, Commonwealth Bank of Australia, National Australia Bank Ltd, and Westpac Banking Corporation) are all among the 100 largest banks in the world and are all AA rated (only 12 of the 100 largest banks have been accorded this rating). Each of these banking groups is committed to embracing best practices in governance and to monitoring developments in corporate governance internationally. They therefore represent a useful case study in sound governance standards.

From a structural perspective, the governance framework of the banking groups can be summarized as follows:

- Board of directors (including board committees)
- CEO
- Heads of business units (direct reports to CEO)
- Chief financial officer (direct report to CEO)
- Heads of central risk management, compliance and audit functions (usually reporting to the chief finance officer or direct to the CEO ie they are independent of the business units)

This paper concentrates on practices at the board level on the grounds that the board of directors is the focal point of corporate governance in a commercial enterprise.

Governance practices can be grouped according to their relationship to structural, process or people issues.

STRUCTURE

The more important structural issues are tabulated below.

1) Board chairman

In each of the four banking groups the chairman is an independent non-executive director (ie there is separation of the roles of the group chairman and the chief executive officer)

2) Board size

Modern thinking is towards more compact boards in the interests of efficiency in decision-making and debate. The size of the boards of the major banking groups ranges from 8 to 13 directors.

3) Majority non-executive directors

Non-executive directors comprise the majority of the board in every case. In fact in three of the four banking groups there is only one executive director (the CEO).

4) Majority independent directors

All of the non-executive directors in each banking group meet formal tests of independence (notably those specified by the Australian Stock Exchange and the particular bank's own independence criteria).

To qualify as "independent", a director must be a non-executive who is free of any business or other association – including those arising out of a substantial shareholding, involvement in past management, acting as a current or past advisor, consultant or auditor, or being a customer or supplier – that could impair the exercise of independent judgement.

5) Tenure

Limits on the time directors may serve vary across the four banking groups but a common pattern involves appointment (subject to election by shareholders at the next AGM) for a term of three years, with a limit (subject to re-election) of three or four terms ie a tenure limit of 9 to12 years.

6) Board committees

Each of the banking groups has the following board committees:

- Audit
- Nominations (alternative titles being "governance" and "board performance and renewal")
- Remuneration (alternative titles being "people" and "people and remuneration")
- Risk

In addition to these four core committees, one banking group has a "technology committee" while another has a "corporate responsibility and sustainability committee".

7) Committee composition

All committees comprise a majority of independent directors.

Only the nominations committee is chaired by the board chairman. The other committees are chaired by independent directors other than the board chairman.

Membership by the board chairman in other committees varies between banking groups – at the extremes, in one case the chairman is not a member of any other committee while in another the board chairman is an ex-officio member of all committees.

CEO participation in board committees is strictly limited. In three of the four banking groups the CEO is not a member of any of the four core committees (in the banking group that is the exception, the only committee that includes the CEO is the risk committee).

A primary objective of the committee process is that deliberations and decision-making should be free of undue influence by the board chairman or the CEO.

8) Access to management

In the case of the audit and risk committees, there must be provision for the committee to meet as regularly as it deems appropriate (and at least annually) with the head of internal audit and the chief risk officer respectively in the absence of other management. The purpose of these private meetings is to enable the committee to be satisfied as to the independence of the function and the objectivity of views and information provided to the committee.

Apart from these formal arrangements, directors have complete and open access to management, subject to keeping the CEO informed to ensure that there is no confusion as to reporting lines and accountability.

PROCESS

A brief overview of selected process issues is provided below.

1) Charters

In each of the four banking groups, the functions and responsibilities of the board are clearly defined in the board charter.

Similarly, each board committee has a charter, approved by the full board, that defines the committee's role, objectives and powers.

Each bank also has a detailed statement that outlines the various components of its corporate governance policies and practices. This statement is included in its annual report to shareholders and is publicly available on each bank's website.

2) Delegated authorities

Each of the banking groups has a comprehensive written delegations policy that specifies matters preserved for decision by the board or its committees, those delegated to the CEO, and those delegated through the CEO to other levels within the organization.

The entire delegated authorities document is typically reviewed annually.

Accountabilities are linked to these authorities.

3) Meeting frequency

The board meeting schedule typically provides for about 10 meetings per year, with provision for additional meetings to deal with urgent or complex matters as deemed necessary.

At least one board meeting per year (usually two meetings) is devoted entirely to strategy development and normally extends over two days at an offsite location.

Board committee meetings occur at least quarterly – and generally more frequently for the audit and risk committees.

4) Meeting agenda and proceedings

Care is taken in designing the board meeting agenda to ensure that priority is given to strategic matters (both strategy design and strategy execution), overall financial performance and sustainability.

The chairman, with input from the CEO, designs the core components of the meeting agenda over a 12 month time horizon to ensure that there is balanced coverage of financial, strategic and major risk areas throughout the year.

Without careful management, board meetings and board papers can become overly immersed in short-term operating and performance issues, to the exclusion of the board's core responsibilities.

In conducting the board meeting the chairman also needs to have close regard for the three distinct functions the board performs:

- It decides (those things preserved for decision by the board)
- It monitors (the performance and financial standing of the business)
- It advises (by acting as a sounding board for senior management and a source of council and advice based on the experience and wisdom of the directors)

5) Ethics

In addition to the legal obligations of directors, each banking group has comprehensive codes of conduct (or statements of professional practice) that set out the ethical standards to which directors are expected to adhere (practice varies as to whether there is a code specifically for directors or whether there is a single code that applies equally to directors, senior executives and all employees).

6) Conflicts of interest

With a board comprised of high calibre directors, the other activities and business connections of directors will inevitably raise conflicts of interest from time to time.

In addition to directors' obligations under the corporations law, each banking group's governance practices specify that when a potential conflict of interest arises, the director concerned must declare that conflicted position. On such declaration, the director concerned:

- Does not receive relevant board papers
- May not be present during board deliberations on the matter
- Is precluded from exercising any influence over other directors on the matter concerned
- May not vote, or be present during a vote, on any related board resolutions

7) Securities trading

In addition to insider trading prohibitions under corporations laws (both in Australia and overseas jurisdictions) each banking group has prescriptive restrictions on trading by directors (and employees) in the shares of the company.

The specifics of these restrictions vary, but it is common for dealing to be restricted to specified "windows" during the year and, even when dealing is permitted, directors are precluded from engaging in trading of a short-term nature.

8) Director education

Common practice involves-

- A directors' handbook containing a broad range of information on matters relevant to the role
- A formal induction program
- Provision for continuing education, involving information sessions and workshops (conducted by internal and external experts) and site visits (both within the business and to other entities, both within Australia and overseas, which may be repositories of knowledge and experience of particular relevance to the business).

9) Advice

The board collectively, and each director individually, has the right to seek independent professional advice, at the company's expense, to help them to discharge their responsibilities.

In the case of directors acting individually, the chairman's approval is needed before seeking advice, but this may not be unreasonably withheld.

Where an individual director obtains such advice it should be made available to all directors.

10) Performance evaluation

A major development over recent years has been an intensified and formal process of assessing and reviewing the performance of the board collectively, of board committees and of each director individually.

Evaluation practices include:

- A defined process for annually reviewing the board's performance, policies and practices
- Completion of written surveys/questionnaires by directors and senior executives
- One-on-one meetings by the chairman with individual directors
- Engagement of an external expert/consultant to facilitate the board evaluation process every second year
- Assessment of the quality and effectiveness of board papers and other information made available to directors
- A separate review of the effectiveness of the board chairman (commonly undertaken by the nominations committee in the absence of the board chairman)
- Allocation of time at the end of each board meeting for non-executive directors to meet in the absence of the CEO and other executives
- One bank employs the practice of appointing a director at each meeting, on a revolving basis, to critique the meeting and report his/her findings at the conclusion of the meeting.

PEOPLE

1) Primacy of people

The people dimension is of critical importance.

Good governance occurs through good behaviours, leading to good outcomes.

Well designed structures and efficient processes do not guarantee good behaviours.

Selecting the right people to serve as directors is therefore of paramount importance.

2) Fit and proper

Each of the banking groups has a comprehensive and robust framework to ensure that individuals considered for board or senior executive appointments have the fitness and propriety to discharge their prudential responsibilities.

These internal requirements can readily be dovetailed with the fit and proper compliance standards set by the prudential regulator (APRA in the case of Australia).

3) Selection criteria

The banking groups have their own specific criteria (undisclosed) for director selection but generic requirements embrace propriety, skills, qualifications, experience, communication capabilities and community standing.

A useful framework that can be applied to the essential qualities of directors involves the six "i's":

- **Integrity** - the highest ethical standards are sought in bank directors
- **Intellectual capacity** - given the complexities involved and the cerebral nature of the role, bank directors need to be highly intelligent
- **Independent thinking** - this attribute involves both an instinct to get to the heart of complex issues and an ability to exercise independent judgement without being unduly influenced by the views of management or other parties
- **Interpersonal skills** - directors must be able to work within the board as a collegial process, with the capacity to express their views forthrightly but also to respect and absorb alternative perspectives of fellow directors
- **Interest** - a director must be genuinely interested in the company itself and the financial services industry more generally, with that interest being reinforced by the experience and expertise that the director brings to the board table
- **Intent** - all directors must have the capacity and commitment to devote the time required to be fully effective as a director of the bank.

4) Mix

Commensurate with the tendency for boards to be of smaller size, increased attention is now given to finding the right combination of skills and experience among the directors when considered collectively. This is one of the key responsibilities of the nominations committee of the board.

Each banking group strives to create a board of directors with the optimum balance of skills, knowledge, and diversity of experience and perspective across the ranks of the directors.

5) Renewal

A further critical role of the nominations committee is to undertake succession planning, both for the role of chairman and by having a selection of potential candidates to replace each director in the event that this may be required.

In addition to replacement planning, careful regard is paid to the desirability of new director appointments to ensure that the board receives the benefit of new thinking and recent or different experiences. While a core of experienced directors is sought, the injection of new ideas and expertise is also desirable, particularly given the change dynamics in the financial services industry.

Notably, one banking group has renamed its nominations committee as the “board performance and renewal committee” as a clear signal of the importance placed on the renewal dimension.

CONCLUSION

The PowerPoint material that accompanies this paper includes a checklist that can be used to compare governance practices of other institutions in other regimes with the best practices outlined above.

The intention is not to prescribe these practices as mandatory but to create a means to identify variances. Where non-compliance is apparent, the reason for the variation can then be sought. In other words, the approach being suggested is along the lines of “if not, why not?” Where, after due consideration, a different practice can be confidently judged to deliver good governance outcomes there ought not to be reason for concern. But where there are material gaps or deviations that could lead to inferior governance outcomes, regulators ought to take remedial action.

Effective corporate governance of financial institutions is critical to the maintenance of public confidence in those institutions, with linkages to systemic stability and national economic performance. Careful attention to corporate governance practices is therefore an integral component of prudential supervision of financial institutions.

Further information about the practices of the four major Australian banking groups can be obtained from the comprehensive corporate governance statements that are available on their respective websites.

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Best Practice in Corporate Governance

Presented by

Paul McCarthy

APEC – Enhancing Risk Management and Governance

December 2008

Agenda

- Concepts
- Structures
- Process
- People
- Checklist

Agenda

- ➢**Concepts**
- ➢Structures
- ➢Process
- ➢People
- ➢Checklist

The Genesis of Corporate Governance

Corporate governance has only recently emerged as a discipline in its own right, although the strands of political economy it embraces stretch back through centuries.

The World Bank, 1999

Corporate Governance – How Broad?

- Our focus is on the role of the Board of directors
- Reconcile separation of ownership and control
- Governance is not management

What do we mean by Corporate Governance?

- System by which companies are directed and controlled. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed and how performance is optimised.
- The process by which corporations are made responsive to the rights and wishes of stakeholders.

Best Practice from Australia's Big Banks

- Four major banks are AA rated (only 12 in the world)
- Among the 100 biggest banks in the world
- Have remained financially sound and profitable
- Committed to highest standards of governance

Agenda

- Concepts
- **Structures**
- Process
- People
- Checklist

Structures – the leaders

- Chairman separate from CEO
- In practice as well as name
- Processes to obviate "dominance by personality"

Structures – the Board

- Mix of skills and experience (minimum size)
- Efficiency in decision-making and debate (maximum size)
- Compact size – about 10/12 directors
- Board renewal – tenure limits and injection of new talent

Structures - Independence

- Majority of independent directors
- Non-executive director (not current or past employee)
- No association with a substantial shareholder
- No connection with supplier or customer
- Not past or present auditor, consultant or adviser
- Objective – independence in thinking, debate & decisions

Structures – Executive Directors

- Compact Board size and majority independent directors
- Strictly limits room for executive directors
- Board's role is to oversee management – challenge, motivate, advise
- Strong case for CEO as only executive director

Structures – Board Committees

- Nominations Committee
- Audit Committee
- Remuneration Committee
- Risk Committee
- Nominations is only committee chaired by Board chairman
- Chairs of other committees based on expertise & experience
- Committee members normally all independent directors
- CEO attends (as required) as executive not as director

Agenda

- Concepts
- Structures
- Process
- People
- Checklist

The Three Dimensional Board

1. Monitor
2. Decide
3. Advise

Board Process - Charters

- Board charter – functions and responsibilities
- Committee charters – role, objectives and powers
- Delegated authorities – board, committees, CEO, staff
- Accountabilities linked to authorities
- Delegations policy document reviewed annually
- Detailed corporate governance statement

Board Process - Meetings

- Meet monthly
- Annual meeting plan
- Agenda linked to priorities (strategy, risk & financials)
- Two meetings exclusively on strategy
- Audit and Risk Committees meet every 2 months
- Other committees at least quarterly
- Audit Committee access to head of internal auditor
- Risk Committee access to chief risk officer

Board Process - Ethics

- Code of conduct – statement of ethical standards
- Confidentiality a critical requirement
- Conflicts of interest to be disclosed
- Not receive papers, absent from discussion, not vote
- Restrictions on share trading – “windows” & short-term

Board Process – Support for Directors

- Formal induction program
- Directors' handbook
- Continuing education
- Access to independent professional advice

Board Process – Performance Evaluation

- Formal annual review of Board, committees, directors
- Use of external consultant every second year
- Separate assessment of effectiveness of Board chairman
- Assessment of quality of Board papers
- Regular discussions in absence of executives (incl CEO)

Agenda

- Concepts
- Roles
- Structures
- **People**
- Checklist

Essential Qualities of Directors – the 6 "i's"

1. Integrity
2. Intellectual Capacity
3. Interpersonal Skills
4. Independent thinking
5. Interest
6. Intent

Director selection

- The Board must establish (guided by the Nominations Committee) a set of criteria for director appointments
- The aim is to create and maintain a Board capable of overseeing, challenging, stretching and motivating management

The role of Directors

As defined by CBA, directors are expected to:

- Operate as part of an exceptional **team**
- Exhibit impeccable values
- Input strongly to risk management, strategy and policy
- Provide skills & experience required now and for the future
- Be excellently prepared and receive all necessary education
- Provide valuable insights and input to management
- Vigorously debate and challenge management

Agenda

- ➢Concepts
- ➢Structures
- ➢Process
- ➢People
- ➢**Checklist**

Governance checklist

1. Beware dominant chairman or CEO
2. Majority of truly independent directors
3. Effective Board and committee structure
4. Responsibilities, authorities & accountabilities defined
5. Ethical standards prescribed
6. Effective Board and committee process
7. Agenda focussed on right priorities
8. Quality of Board papers and executive input

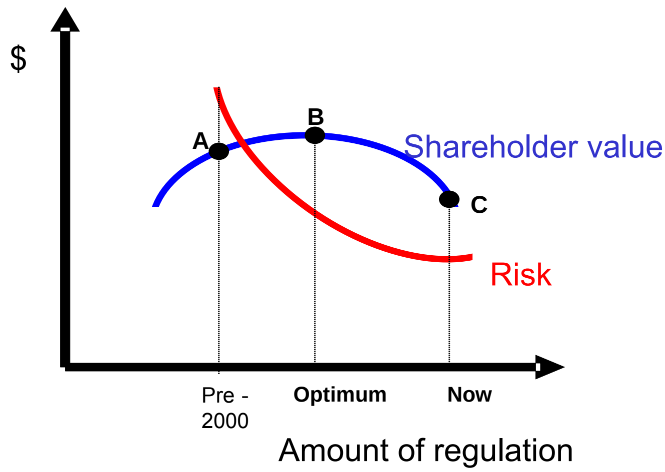
Governance Checklist continued

9. Conflict of interest provisions clear and effective
10. Securities trading by directors strictly controlled
11. Rigorous annual evaluation of Board performance
12. Individual directors of high calibre (acumen & integrity)
13. Effective mix of expertise, experience and perspective
14. Diligent attention to Board renewal

Supplementary material

1. The regulatory trade-off
2. Issues in developing markets
3. Responsibilities of the board
4. Australian banks' attention to governance
5. Australian banks governance overview
6. Australian banks board committees
7. Reference material
8. Supplementary readings

The Governance Trade-off



Issues for Corporate Boards in Developing Markets

1. Concentration of Ownership
2. Appointment Process
3. Role Clarity
4. Information Quality
5. Local Culture
6. Legal Deficiencies

Source: The McKinsey Quarterly, 2006, Number 1

Responsibilities of the Board

- Corporate governance
- Oversight of the business and affairs of the company, including:
  - strategies and financial objectives
  - approving major initiatives and capital expenditure
  - risk management
  - management performance
- Appointment of CEO
- HR policies
- Reports to shareholders

Australian Banks' Attention to Governance

	ANZ	CBA	NAB	WBC
Corporate Governance Statements – Number of pages	11	8	10	17

Websites

WWW.ANZBANK.COM
WWW.COMMBANK.COM.AU
WWW.NABGROUP.COM
WWW.WESTPAC.COM.AU

Australian Banks Governance Overview

	ANZ	CBA	NAB	WBC
Role Clarity	√	√	√	√
Non-Exec Chairman	√	√	√	√
Board Size	9	10	14	9
Non-Exec/Exec Directors	8/1	9/1	11/3	8/1
Independence Provisions	√	√	√	√
Performance Reviews	√	√	√	√
Codes of Conduct	√	√	√	√
Audit Committee	√	√	√	√
Nominations Committee	√	√	√	√
Remuneration Committee	√	√	√	√
Risk Committee	√	√	√	√
Other Committees	Technology	-	-	Social Responsibility

Australian Banks Board Committees

	ANZ	CBA	NAB	WBC
Audit Committee				
Board Chairman Member	√	X	X	√
Board Chairman Chair	X	X	X	X
CEO Member	X	X	X	X
Nominations Committee				
Board Chairman Member	√	√	√	√
Board Chairman Chair	X	√	√	√
CEO Member	X	X	X	X
Remuneration Committee				
Board Chairman Member	√	√	X	√
Board Chairman Chair	X	X	X	X
CEO Member	X	X	X	X
Risk Committee				
Board Chairman Member	√	√	X	√
Board Chairman Chair	X	X	X	X
CEO Member	X	√	√	X

Reference material

- OECD - Principles of Corporate Governance
- OECD - White Paper on Corporate Governance in Asia
- ASX Corporate Governance Council – Principles of Good Corporate Governance and Best Practice Recommendations
- Asian Development Bank Institute – Corporate Governance in Asia: Recent evidence from Indonesia, Korea, Thailand and Malaysia
- Harvard Business Review 9/02 – What Makes Great Boards Great
- Harvard Business Review 3/03 – The Board's Missing Link
- The McKinsey Quarterly 02/4 – Change Across the Board
- The McKinsey Quarterly 06/1 – Improving Board Performance in Emerging Markets
- The Economist 28/5/05 – The Biggest Contract

Supplementary Readings (books)

- Theories of Corporate Governance by Thomas Clarke
- Corporate Governance and Chairmanship: A Personal View by Sir Adrian Cadbury
- Back to the Drawing Board: Designing Corporate Boards for a Complex World by Colin Carter and Jay Lorsch
- The Recurrent Crisis in Corporate Governance by Paul MacAvoy and Ira Millstein