

# Corporate Governance: Regulation and Supervision Guidelines

2013



ASSOCIATION OF SUPERVISORS  
OF BANKS OF THE AMERICAS



Multilateral Investment Fund  
Member of the IDB Group



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OF BANKS OF THE AMERICAS



**Corporate Governance:  
Regulation and Supervision Guidelines**

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To request a printed copy, contact:  
[asba@asba-supervisión.org](mailto:asba@asba-supervisión.org)

C. Picacho Ajusco # 238, Oficina 601  
Col. Jardines en la Montaña, C.P. 14210, México, D.F.  
Tels. (52-55) 5662-0085, Fax (52-55) 2615-5603

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# I. INTRODUCTION

The Americas have faced several financial crises that have led to the discussion and promotion of regulatory and supervisory changes to the financial system in order to preserve stability. Corporate governance is among the topics that regulators should consider, given that the implementation of good practices in this area have great relevance for the success of an institution and the financial system, as a whole.

International organizations, such as the Basel Committee for Banking Supervision have conducted some work in this field, developing guidelines for the Evaluation of Corporate Governance in 1999, 2006, and 2010. In a similar manner, the Association of Supervisors of Banks of the Americas (ASBA), representing regional supervisors, has been aware of this topic and has developed specialized papers

on the subject, such as Corporate Governance in Bank Supervisory Agencies (2008) and Corporate Governance in Banking Institutions (2009). In addition, ASBA has provided various training courses and seminars. All this experience encompasses the background for the development of this paper.

Considering the importance of developing a guideline covering best practices for the regulation and supervision of corporate governance, ASBA has conducted this work to be applied in the region. Initially, a regional assessment was conducted to study the basic needs within the legal framework, based on which the authors developed the guidelines presented in this paper. The paper is structured as follows: Chapter II covers a set of preconditions that should be met to develop an adequate Corporate Governance in financial institutions, as well as its regulatory and supervisory process; Chapter III introduces the regulatory proposal; Chapter IV presents topics related to the Supervisory process; Chapter V refers to implementation guidelines; finally, Chapter VI covers Corporate Governance topics to be considered in public banks. The document includes an annex which presents a regional assessment and major advances in the development of corporate governance practices.





Regulation



## II. REGIONAL PRECONDITIONS FOR A BETTER IMPLEMENTATION OF CORPORATE GOVERNANCE FRAMEWORKS

This chapter will cover the minimum requirements or preconditions necessary for an adequate Corporate Governance in financial institutions, as well as its regulation and supervision. Among these preconditions, we can find aspects linked to the political and institutional system, as well as the rules guiding the functioning of societies, which are part of the general framework of rules and circumstances under which financial institutions operate. These are not part of this work as they are related to the operation of societies. Thus, the paper focuses only on minimum aspects that should be present in the legal framework for an adequate functioning of societies and a proper empowerment of banking supervisors.

### II.1. Legal Framework

An adequate legal framework for Corporate Governance in financial institutions should, as a minimum, include: the main responsibilities, rights, and obligations of shareholders and directors. Legal frameworks are costly and difficult to modify, therefore it should include aspects that are expected to have some permanence over time. At the same time, the legal framework should avoid including administrative regulation that would require modifications in the short-term. Given their own nature, laws have a higher hierarchy than regula-

tions; therefore, several countries use laws to provide greater legal certainty to investors, as well as other parties affected.

The following paragraphs present the minimum legal framework for the proper functioning of Corporate Governance in financial institutions. This minimum framework may be extended to include topics covered in the regulation chapter, depending on each country's tradition to include these aspects in laws or regulations issued by the regulator. On this basis, this chapter will address two basic aspects, considered as prerequisites for developing an adequate regulation and supervision of Corporate Governance:

- 1) Legal aspects essential for the functioning of commercial entities in general, and banking institutions in particular. Usually these aspects are found in commercial and corporate law, banking and financial law, or similar.
- 2) The powers and abilities supervisory agencies must have.

#### 1) Legal Aspects for the Functioning of Societies

These types of laws regulate several aspects of the life of societies. The following include topics considered to be the most significant from a Corporate Governance point of view in financial institutions. These include: the various legal forms that intermediaries may adopt, the obligation to know the owners, the rights and responsibilities of owners and Directors, and the functioning of the Assembly and the Board.

##### *a. Regarding the Owners:*

- The legal forms which financial institutions may adopt must be defined. In general, most are chartered as corporations based on shares, among these one can find: cooperatives, foreign bank branches, and State-owned banks.
- In case of share concentration, when a shareholder owns more than 3% or 5% of a bank, supervisors should have the power to identify the ultimate owner, beyond any mechanisms used by shareholders to conceal their identity, including intermediary societies.

- Laws should define owner’s main rights, among others:
  - ~ Participation and voting in Assemblies.
  - ~ Profit sharing.
  - ~ Management oversight of the company.
  - ~ Preference in acquiring shares when new shares are issued.
  - ~ Exercise the right to withdrawal in cases provided by law.
  - ~ Call for an Assembly, if the minimum votes required are expected to be met.
  - ~ Propose Directors.
  - ~ Receive information about: the condition of the entity, proposals raised in the Assembly, acting payroll of Directors and list of proposed Directors, financial statements, reports and minutes, proposals to modify statutes, external auditors’ report, and list of shareholders.
- If a conflict of interest exists, it must be explained and the involved parties should abstain from voting.
- The Assembly is the body where owners express their opinions. Its main powers should be:
  - ~ Appoint and remove Directors, and set their remuneration.
  - ~ Approve financial statements.
  - ~ Modify the social contract.
  - ~ Increase and decrease capital in the entity.
  - ~ Issue and redemption of shares.
  - ~ Provide an opinion and/or exercise the right to vote in case of a dissolution, merger or acquisition.
  - ~ Participate in the dividend distribution policy.
  - ~ Authorize shares not covered in the social contract.

### *b. Regarding the Directors and the Board.*

- The Board is, by excellence, the governing body for corporate control. The Board represents the interests of the owners and controls Management. Its main functions and the conditions that its member should

meet have to be clearly detailed. Next chapter which covers regulation further develops these topics.

- The main conditions to be a Director are related to their moral character and the fulfillment of their duties of loyalty, care, and due diligence.
  - ~ Directors should not have been disqualified by a body with sufficient powers. Directors must also exercise the duty of loyalty to owners, by avoiding any conflict of interest.
  - ~ Directors must understand and perform all the necessary analysis that would allow them to make decisions in good faith, and in the honest belief that such actions benefit the interests of the entity.
  - ~ Directors must provide sufficient guarantee.
  - ~ Directors are required to guide the business, actively participating and controlling management.
  - ~ Directors must have the power to appoint managers, evaluate, and replace them.
  - ~ Directors must comply with laws, regulations, and statutes.
  - ~ Directors should participate in defining the schedule of meeting, and voting scheme of the Board.

## 2) Supervisory Powers and Capabilities

As for the supervisor, it is essential that the law exert regulatory and supervisory powers with regard to Corporate Governance in the entities under its control. Thus, during the authorization process the supervisor would evaluate whether: shareholders are adequate, or if the design of the entity’s Corporate Governance, its members, as well as its internal control system and risk management controls are in accordance to the entity’s business plans. At this point, it is important to clarify that supervisors should have sufficient powers to authorize or revoke members of the Board and senior staff for reasons of legality, opportunity and convenience throughout the life cycle of the supervised entity, and to require necessary modifications in the Governance structure of the entity.

The supervisory authority must adopt a risk-based supervisory process. The regulation and supervision of the Corporate Governance should be performed under this framework, since it is essential that it is carried out in accordance to the nature, size, complexity and risk profile of the entity. With this in mind, it is easier to develop a Corporate Governance structure based on its functions and the risks it would face.

This implies an important challenge for the supervisor, who would have to move from verifying compliance to a risk-based supervision, in which the supervisor would have to issue opinions on the business plan, level of risk, the quality of the risk management system, internal controls, and Corporate Governance of the entity. To achieve this, significant efforts would be necessary in training supervisors in these disciplines. This training and gradual pilot plans are basic at the time of implementing supervisory models of this nature.

# III. PROPOSAL FOR THE REGULATION OF CORPORATE GOVERNANCE

This section discusses the regulatory proposal for Corporate Governance in financial intermediaries. This proposal covers both large and systemically important institutions, as well as smaller institutions. As the regulatory recommendations will cover various types of institutions, it is worth noting that rules must be adapted according to the size, nature, complexity and risk profile of each institution. Hence, the proposal will define the principle to be met, but will refrain from establishing how to comply with it. The latter is related to the specific nature of each supervised entity, according to the factors identified above.

In addition, please note that this paper does not take into account Corporate Governance practices in financial conglomerates, which may differ from that of other conglomerate units. To address Corporate Governance in financial conglomerates, ASBA has published in December 2010 a document entitled “Best Practices Guide and Recommendations for the Regulation and Supervision of Financial Conglomerates,” which includes a specific chapter on Corporate Governance.

This document has been drafted considering the regional assessment, best practices developed by international organizations, and regulatory frameworks of countries in the region. To continue the analysis, it is important to define what corporate governance is in terms of this paper:

Corporate Governance refers to the way in which institutions are organized to direct and control their management. It is comprised by the leadership structures of the institution (the Board or equivalent hierarchical authority, and its Committees), management (Senior Management), and those regarding control (Internal and External Audit, among others); as well as any practices adopted to manage, oversee and control daily business activities, within the framework of the applicable laws and regulations. These practices should allow the entity to establish its objectives, determine the necessary means to reach them, and monitor their compliance. In all cases, performance should be in accordance with the best interests of the institution, its shareholders, depositors and creditors, and respecting consumer rights and those of other groups of interest. Corporate governance will also require the entity's officers to adhere by these practices.

The following cover the main components of the regulatory framework for Corporate Governance in financial intermediaries:

- III.1. Corporate Governance in the authorization process
- III.2. Ownership Structure and Decision-Making Bodies
- III.3. Board of Directors
- III.4. Chairman of the Board
- III.5. Board Committees
- III.6. Control Functions: Internal and External Auditors
- III.7. Senior Management: Risk Management and the Compliance function
- III.8. Compensation Systems
- III.9. Information Disclosure

## III.1. Corporate Governance in the Authorization Process

During the authorization process, supervisors should evaluate the financial institution's Corporate Governance as one of the main elements. At this point, it should be emphasized that the Supervisor should have the power to require any information

related to the institution's governance to allow him/her for an optimal assessment. The Supervisor may deny the authorization, if he considers the Corporate Governance design to be inappropriate or to obstruct an adequate supervisory oversight. Similarly, supervisors should also have the power to veto modifications in the entity's senior staff (i.e. Directors, Chief Officers, Risk Managers and Auditor) and have the power to require changes in the organizational structure when deemed appropriate.

According to the above, regulation regarding the authorization process shall include the following, as a minimum:

1. As part of the authorization requirements, the institution requesting a license must submit all information available on its Corporate Governance structure. This information shall include at least the following: ownership structure, organizational structure, policies to mitigate potential conflicts of interest, structure of risks, internal control mechanisms, regulatory compliance, the strategic and business plans, as well as the skills, experience and integrity of the Directors and senior management. The supervisory authority will have the power to request any other information it deems pertinent.
2. Among the powers of the Supervisor, supervisor must have the power to deny an authorization for failure to have an adequate Corporate Governance design.
3. Supervisors should be able to grant a "no objection" to the institution's senior management at all times, as well as any modifications along the way. This authorization must cover at least, the Board, the Chief Executive Officer, the Internal Auditor, and the Risk Manager. In addition, the supervisor should have the power to require changes in the organizational structure and the removal of senior staff.

### III.2. Ownership Structure and Decision-Making Bodies

The supervisor should have the ability to know and authorize the ownership structure of a financial entity. To accomplish this, it is fundamental that the supervisor understands the ownership structure to

have an accurate perception of the internal distribution of the institution. The ideal level of transparency is one in which the supervisor is able to understand the ownership structure of the institution's shares and can identify each shareholder or ultimate beneficiary, whether they are a natural or legal person. In addition, every effort should be made for the legal framework to allow the supervisor to identify any shareholder with a 5% ownership or higher, or any other percentage defined as relevant.

In the case of branches of foreign financial entities, it is necessary for supervisors to have full authority to determine the real beneficiary under oversight by the home supervisory authority. The host authority should also ensure an equivalent and reciprocal supervisory process to that applied to entities in their own country. Therefore, every structure should identify its owners, at least those holding a significant percentage of shares. In addition, the supervisor should authorize any changes in shareholding greater than a previously established minimum percentage (e.g., a change in ownership structure of more than 5% of capital).

The supervisor must ensure that shareholders can exercise their rights, both economic and political, as well as search for mechanisms to encourage a greater participation in the decisions of the entity.

Regarding this point, the norms should establish that:

1. Financial intermediation entities should be organized as corporations or other legal form, recognized and authorized by the supervisor, which allow for a permanent identification of the entity's shareholders. In case of related or connected shareholders or owners, supervisors should have knowledge of the owners' relationship and identify the shareholder who exercises effective control of the group.
2. Any transfer or increase of shares, by an amount greater than 5% of capital or any other minimum percentage previously established by regulation, should require supervisory approval. For this purpose, the supervisor would require information on the shareholder, regarding his background, integrity and solvency. In case the new owner is a foreign financial institution, the supervisor may collect

data, such as the authorization of the home supervisor, the information sharing agreement between supervisors, and the risk rating. The supervisor's approval decision on the issuance or transfer of shares should be based on legal grounds, opportunity, and convenience.

3. The principle of equality should be implemented, in other words, to equal ownership should correspond equal rights. There may be shares with no voting rights (i.e. preferred shares), but these should represent a minority participation (for example, no more than 50% of ordinary shares).
4. Participation and information. The effective exercise of shareholders' rights should be secured by notifying shareholders, with due anticipation about future Assembly meetings and provide them with clear, timely and complete information to make informed decisions. To achieve this, it is necessary to clearly define the communication channels through which shareholders access the information they need to make decisions. In cases where the shareholder structure justifies it, there should be an investors' relations office.

### III.3. Board of Directors<sup>1</sup>

The Board is the maximum responsible body for the organization and its members are elected by the owners. It is the ultimate responsible body for approving Corporate Governance policies, corporate values, strategies and business plans, the level of risk the entity is willing to assume, as well as appoint, monitor, evaluate, and replace Senior Management.

Board members should have the necessary knowledge and skills to clearly understand their responsibilities and duties within the entity's corporate governance, and act with the loyalty and due diligence of a prudent businessperson in the affairs of the financial entity. From the above, the regulatory principles for the Board are:

1. The Board must maintain an appropriate structure, in number and composition of its

members, which would allow for an independent view of Management and any other external interest. It is a good practice for the Board to be comprised of five members, as a minimum; however, larger and more complex institutions are expected to have a Board with as many as 15 members.

To maintain independence, it is necessary that no Director exerts a significant influence on the functioning of the Board. In addition, neither the body nor its non-executive members should be involved in the daily management of the entity. However, they may participate in operational decisions that are considered highly important or strategic, having knowledge of the entity's main operations. The Board should be comprised of an adequate number of non-executive and independent directors<sup>2</sup>. It is considered good practice to ensure a proper balance between non-executive, independent and executive directors, so that independent and non-executive directors are a majority in the Board.

2. Directors must commit the time and dedication necessary to properly exercise their duties, attending Board meetings and Committees properly prepared to discuss the issues at hand.
3. There should be an operations manual for the Board, setting the frequency of meetings, the designation process and nomination of Directors, their removal process, the election process for the Chairman of the Board, the voting procedures, the information disclosure practices to Board members, the accountability mechanisms for the Committees, and how decisions are made, among other relevant aspects.
4. Board members must be competent for office, they must clearly understand their mission and duties within the entity's corporate gover-

<sup>1</sup> The terms Board of Directors and Board will be used interchangeably.

<sup>2</sup> Non-executive directors are those who do not exercise managerial functions in the entity. Independent Directors are those who in the past years have not been part of the entity, have not had relevant commercial, professional or family relationships or with it, or with the management or economic group to which it belongs.

nance, and be able to exercise good judgment in issues pertaining to the financial entity. To achieve this, the Board should fully understand the banking/financial business and have the expertise to manage it. Board members must be selected based on their professional prestige, background, experience and knowledge, seeking for an appropriate balance between the characteristics of the Directors, in accordance with the business, complexity and risk level of the entity.

5. The Board must promote training and development of its members on topics, such as corporate governance, comprehensive risk management, internal control, finance, regulation, and new products, among others. This training will allow members to have an adequate knowledge of the bank's business, the risks the entity is exposed to, as well as its economic capital and strategy. Training should be mainly directed at non-executive and independent members. Therefore, there must be an annual continuous education program for Board members. It is expected for the Board as a whole to understand its role in the Corporate Governance of the institution.
6. The Board must perform a periodic self-evaluation, both as whole and of each of its members.
7. The Board must approve the entity's strategic objectives. In other words, it must approve a strategic framework that defines the lines of business, the expected returns, and the risk assumed. This must be communicated to the entity by the Board, ensuring the effective dissemination of these objectives. To achieve this, it is necessary to establish a business plan and evaluate the financial results, requiring explanations when deviations occur. The Board should also review the entity's strategic objectives, risk profile, and business plans on an annual basis. Should any changes be required, these must be carried out with the required periodicity and in accordance to the environment in which the entity operates.
8. The Board should adopt a risk strategy and related policies that would allow for the identification and analysis of the entity's objectives, both individually and on a consolidated basis. To achieve this, it must promote a culture of risk, understanding each of the risks to which the entity is exposed to, and defining the level of risk exposure. The Board should approve the entity's risk strategy, which must include the types of risk and tolerance levels to be assumed. This strategy must be consistent with the business plan. It must also ensure that management takes steps to establish a comprehensive risk management system, which has the necessary resources to manage the risks to which the entity is exposed to, and that written procedures are in place and implemented at all times.
9. The Board must implement a process to ensure that the level and quality of capital is sufficient to cover the risk profile of the institution. It must define policies and procedures to manage capital in all units of the group, and review the level of allocated capital at least on an annual basis.
10. The Board should select, evaluate and, if necessary, replace senior management. For this, it must have established procedures to regularly evaluate management, ensure that they meet the criteria of ability, experience, reputation and integrity. The Board should also define in writing the roles and responsibilities of management and a succession plan.
11. The Board should promote a culture of control in the entity, making sure that Management implements policies and procedures for all staff of the institution to understand their role in internal control and risk management. To achieve this, it must approve an organizational structure that takes into account a clear separation between the commercial and control functions, ensuring the existence of crosschecking mechanisms.
12. The Board must ensure that a Management Information System is in place, which is comprehensive, reliable, timely, and that allows for appropriate decision-making.
13. The Board must promote a corporate culture that demands and provides appropriate incen-

tives for an ethical conduct, avoiding potential conflicts of interest and managing them if necessary. The Code of Ethics should include the entity's corporate values and minimum standards of conduct. This Code should also include, as a minimum, the obligations to: comply with laws and regulation; implement the strategy and policies; avoid conflicts of interest, if present; define the process for managing conflicts of interest; facilitate communication channels for employees to report fraud, irregularities, and illicit acts; and to establish a fair treatment for employees and customers.

Directors and Managers must incorporate this Code of Ethics into their decision-making to avoid potential conflicts of interest; both should constitute an example of conduct. It is considered good practice to ensure that there are policies and procedures for managing operations carried out between the entity and senior staff or related parties. In addition, Directors and Managers, when assuming their positions, should make a sworn statement which includes all companies or institutions to which they have been linked to in the past two years.

14. The Board must provide regular financial, operational, and management information for market participants to evaluate the entity. The scope and content of the information provided to the market and its level of disaggregation should be consistent with the size, complexity, risk level, and nature of the institution's operations.
15. The Board shall approve a Corporate Governance Code, which includes the organizational structure, the units that comprise the entity, the decision-making mechanisms, the accountability processes for Management and the Board, the profiles and selection procedures for Management and Board members, and the staff performance evaluation systems. This Code must be periodically disseminated and reviewed.
16. The Board should promote the work of both, the Internal and External Audit functions by acknowledging their importance, and periodically following-up on the observations they make.

### III.4. Chairman of the Board

The performance of the Chairman of the Board is essential for the proper functioning of an entity's Corporate Governance, combining financial expertise with leadership skills. Given the Chairman is primarily responsible for the proper functioning of the Board, he should be trained and introduced into the bank's activities, and spend most of his time performing his duties. As the ultimate responsible party, it is his obligation to encourage all members to participate in decision-making, especially the non-executive and independent members, and that all members receive timely information to act as an effective counterweight to management. As a result, the regulatory principles include the following:

1. The Chairman of the Board must show integrity in his conduct and have sufficient knowledge, experience and background to hold office in the institution. He must know the business in its entirety, and must devote much of his time to his duties. In all cases, the Chairman must be a non-executive member of the Board.
2. He must run the Board in accordance with approved procedures, respecting and enforcing Corporate Governance policies. It is essential for him to promote the participation of all members, especially that of non-executive and independent directors, providing the information in a timely and relevant manner.

### III.5. Board Committees

The Board may decide to organize their work by establishing various Committees. These Committees perform functions delegated by the Board, and should be distinguished from those organized for the daily management of the entity (which are established as part of Management). These committees can increase the participation of independent directors in the entity's decision-making.

Therefore, it is necessary to include rules on the minimum practices of these bodies.

1. **Audit Committee.** This Committee should be mainly composed of independent and non-executive Directors, competent in the areas of auditing, accounting and finance, as well as extensive knowledge of the business. It must be chaired by an independent member

of the Board. Its main functions are: to ensure the proper functioning of the entity's Comprehensive Risk Management and internal control systems, proposing measures deemed necessary for their improvement; report to the Board on limitations in the reliability of accounting and financial processes, including the management information system; approve the annual Internal Audit plan; propose the appointment of the external auditor, reviewing his work; and follow up on the recommendations made by the Internal and External Auditors, as well as the Supervisor.

2. **Risk Committee.** This Committee should be composed mainly of non-executive and independent Board members. It should be conducted with a holistic, comprehensive vision of the risks to which the entity is exposed to. It should be chaired by an independent director and include other independent directors. Its main functions are to: propose the adoption of policies and recommendations on the structure of the comprehensive risk management system, and any necessary changes; define the tolerance level and exposure level to risk the entity is willing to take; periodically assess the risk level and take actions to correct course in case of deviations to levels set in policies; regularly evaluate the entity's capital in relation to the entity's risk level; define the scenarios and time horizon under which approved limits could be breached or exceptions to policies made, as well as possible courses of action or mechanisms by which a given situation is regularized. The definition of scenarios must consider both, events originating in actions of the entity, and surrounding circumstances. Report to the Board of Directors or equivalent authority the results of their assessments of risk exposures of the entity.
3. **Nominations and Compensation Committee.** It should be comprised solely by independent and non-executive directors. Its functions include: reviewing the performance of senior management; proposing a wages and salaries policy for management that is aligned to the business horizon and risk level of the entity;

proposing the appointment of senior management and their removal for failure to meet the standards set by the institution; and, proposing objective criteria by which the institution hires its top executives, among others.

4. **Corporate Governance Committee.** This committee is integrated entirely by Directors. Its main functions are: proposing the Board the adoption and approval of a Corporate Governance Code, which covers the organizational structure, all the entity's units, the decision-making methodology; the accountability processes for Management and the Board; the profiles and procedures to elect Board members and Management, as well as the performance evaluation systems; reviewing, through the compliance function, the application of the Code approved by the Board; and, reviewing the dissemination of information by the company ensuring that stakeholders have access to sufficient information on the entity.
5. **Functioning of the Committees.** Committees must have regular meetings and be accountable to the Board. These bodies must develop rules of operation approved by the Board, such rules should establish criteria to avoid conflicts of interest, incompatibility in performing specific functions, frequency of meetings, voting mechanisms, procedures for distributing information to members, accountability procedures to the Board and description of the decision-making process, including minutes and any other necessary mechanisms to verify their integrity. If necessary, Directors may engage expert resources to complement the vision and work of the various committees. The Chairmen of the Committees will be appointed by the Board and must rotate, as well as all their members. In small institutions, the functions of the Risk Committee, Nominations and Compensation Committee, and the Corporate Governance Committee may be assumed by the Board of Directors. The members of the support committees must have the necessary knowledge or experience according to the applicable rules and requirements approved by the Board or equivalent body.

### III.6. Control Functions: Internal and External Auditors

Control functions are a very useful tool for the Board, since they report on the adequate functioning of the entity. In addition, this fact explains the need for independence in the audit functions. Audits should meet the following standards:

1. The **Internal Auditor** should evaluate and monitor the comprehensive risk management and internal control systems, as well as report to the Board and Audit Committee on the weaknesses found. It should also review and validate the Management Information Systems and departures from laws and regulations in place. To achieve this, internal auditors must develop an Auditing handbook on policies and procedures, which will be submitted for consideration by the Audit Committee. On the other hand, internal auditors must implement processes that enable it to reach firm conclusions, supporting these with documented evidence. Internal auditors must also implement the approved plan and report to the Audit Committee and the Board on the existence of significant deviations and their impact on achieving the entity's objectives. They should also submit performance reports with their findings and recommendations to the Committee for their information and action. In addition, auditors would maintain an inventory of identified weaknesses, the initial date of findings, and correction actions. The Board should define the remuneration of the Internal Auditor.
2. **External Audit** must provide an opinion on the entity's financial statements and other areas the Supervisor may request, providing an independent vision of the institution and its related parties. To accomplish this, they must designate an adequate auditing team, both in quantity and quality, as well as an appropriate auditing plan, and report findings to the Board and Supervisor, paying particular attention to significant findings or results outside the expected range.

### III.7. Senior Management: Risk Management and the Compliance Function.

Management comprises the executive staff, responsible for the daily operations of the institution, included the Chief Executive Officer. Senior Management are expected to have the necessary knowledge, background, and experience to manage their area of responsibility, manage the business, and control the entity's personnel, in accordance to the guidelines established by the Board. To achieve this, they must meet with the following standards:

1. Management, as a team and individually, must possess the knowledge, background and skills to manage and monitor the business under their responsibility. They must work as a team, respecting the entity's structure, its hierarchy and authority. In addition, they must have control over subordinate staff and those working in key areas. Management duties must be in accordance with policies approved by the Board and the Corporate Governance Code.
2. Management must establish and follow a continuous and adequate process for strategically managing the entity in accordance to the guidelines established by the Board, and reporting back to them on the results. To achieve this, management must implement the business plan, periodically review it, and provide timely information to the Board on the evaluation of the plan, any deviations, and explanations thereof. In addition, management must ensure that the entity and its resources are adequate to implement the plan.
3. Management should implement a comprehensive risk management system that: includes the strategy and risk profile defined by the Board, covers all of the entity's staff, and is proactive. The system should have an integrated view of risks, appointing a responsible party for each material risk, developing and implementing processes to identify, measure, monitor and control all risks, including those that can be

occur in the future, as well as ensuring the system has adequate resources in quantity and quality, and that an independent review process is in place.

4. Management should promote a culture of oversight throughout the entity. For this, management should design a system that explains each employee what their role is in the system, how they are expected to act, and the necessary measures to address the problems identified by auditors.
5. Management should implement policies approved by the Board to avoid or manage potential conflicts of interest, and establish control processes to ensure compliance. For this, management must ensure an adequate implementation of procedures for handling transactions with the entity's officers and related parties.
6. Management must define and implement an information system that is reliable, timely, easily accessible, and presented in a consistent manner. The system must meet the following characteristics:
  - Opportunity** - The system must provide updated information in a timely manner to the appropriate users, to facilitate decision-making.
  - Accuracy** – The system of controls over information processing must be effective.
  - Consistency** - The information must be processed and compiled consistently and uniformly. Any changes must be properly documented and clearly communicated to all information users.
  - Integrity** – All decision makers must have complete and pertinent information in synthesized form.
  - Relevance** – Information in excessive detail which may create information overload should be avoided. Information relevance is directly related to the needs of Management and the Board for conducting their work.
7. Management should implement the recommendations made by the Supervisor, and the Internal and External Auditors; document-

ing the improvements made will allow the Board and the Audit Committee to be informed.

8. There should be an area in charge of risk at the highest level of the entity and with sufficient authority, resources, independence and access to the Board or the specific committee in charge of analyzing all risks to which the entity is exposed to; considering risks individually and globally, as well as quantitative and qualitative, stress testing and scenario analysis. It must be a separate area and have no other associated functions. If it depends on the Chief Executive Officer, it must have direct reporting access to the Board or the Risk Committee. The meetings between the Board and the Risk Manager must be documented. Non-executive directors should have access to the Risk Manager periodically, without the presence of Executive Directors. If the Risk Manager is removed, the decision must be taken by the Board, and disclosed and explained to the Supervisor. The entity's risk methodology should apply to new products. An effective risk management strategy also requires robust communication throughout the entity, especially between management and the Board, including the Risk Committee.
9. There must be a compliance function at the highest level, which reports to the Board or the appropriate committee thereof. Its main responsibilities are: to advise the Board on the effective compliance of the law, rules, regulations and corporate governance policies as defined in the entity's Code; to design procedures and controls to ensure that the entity complies with the regulatory framework and the decisions made; to inform the Board on potential deviations; to define communication policies and training to ensure staff understands and applies the legal and regulatory framework applicable to the entity, as well as the policies defined by the Board. This area should not only minimize risks arising from non-compliance, but also encourage sound decisions consistent with the obligations and ethical conduct of the entity.

### III.8. Compensation Systems

Compensation systems seek to align the incentives of senior staff to the entity's goals. Recently, several organizations have developed new regulatory principles for compensation systems to avoid excessive risk-taking due to economic incentives not properly designed.

In this section, we propose the following standards:

1. The Board must be proactive in designing the compensation system and its implementation. Management should not be in charge of it, only independent non-executive members should participate through the Nominating and Compensation Committee. The compensation of Directors must be approved by the shareholders' meeting.
2. The Board should monitor and review whether the compensation system operates as intended, for which controls have been implemented and are tested periodically. In addition, practices should be carefully evaluated to include results that will be reflected in the future. This analysis should include positive and negative cycles of the economy. For this purpose, the Nominating and Compensation Committee shall work along with the Risk Committee.
3. Areas such as Risk Management and Internal Audit should be compensated in a manner that is independent of business results, mainly considering the roles they perform. If their compensation depends on business results, this percentage should be minor. Remuneration should be aligned to established risk policies, and its evaluation must depend on the risk horizon of the entity.
4. Compensation must be adjusted for all types of risk. Quantitative measures and value judgments must play a role in the risk adjustment mechanisms, including those difficult to measure.
5. Compensation results should be symmetric with risk outcomes. There must be a direct relationship between compensation and the entity's long-term performance, as well as staff contribution to such performance.

6. Compensation schemes should be sensitive to entity's risk horizon. Therefore, it should differ according to the types of risk the institution faces (at least 40% of the compensation should be deferred). The deferral must be greater for senior management and should not be less than three years.
7. Compensation policies, as well as the composition and mandate of the Compensation Committee must be communicated on an annual basis.

### III.9. Information Disclosure

To achieve a proper Corporate Governance framework, it is important for the entity to disclose information to stakeholders, whether they are customers, shareholders, suppliers or the market in general. Information disclosure must include key aspects of the entity, including its financial statements, corporate governance design and risk policy. The entity should not provide information that is considered confidential, such as its business strategy. In some instances, the entity should consider providing information on the performance of its senior staff, who acting on privileged information, may pose a conflict of interest with the fiduciary duty to the bank.

Financial intermediation institutions should regularly disseminate information on key aspects of the institution to provide the market with data on the condition of the entity. Information disclosure will depend on the frequency with which information is published.

On a quarterly basis:

- Financial statements.
- Compliance with key prudential regulations (in general, compliance with capital ratios, liquidity and technical measures).

On an annual basis:

- Audited Financial Statements.
- Corporate Governance Report, which covers the following, as a minimum: About the Board (its structure according to the statute, size, members, selection process, qualifications, independence criterion, particular interests in transactions or matters affecting

the financial entity); on Senior Management (responsibilities, reporting lines, qualifications and experience): and on the Committees (mission, objectives, responsibilities and members). Further information should be provided on the basic ownership structure (major shareholders, their participation in the entity's capital and voting rights, as well as their representation in the Board and Senior Management), and the organizational structure (general organization, business lines, subsidiaries, branches, committees).

- Risk Report, including: the structure of the risk function, the Risk Committee members, their profiles, the selection process, the members' particular interests, and the way the

Committee carries out its duties, the entity's position in each risk, the mitigation mechanisms, policies and procedures.

- Compensation System Report, covering information on: the mechanism used to make compensation decisions, as well as the composition and mandate of the Nominating and Compensation Committee. The report should also include the most important features of the system (including any risk adjustment), the relationship with business results, the deferral, and the mix between cash and equity. In addition, the report should cover aggregate quantitative information on employees which own a significant amount of shares that could have a material impact on the risk exposure of the entity.





# Supervisory Guide



## IV. SUPERVISORY GUIDE

As described previously, Corporate Governance oversight requires a significant amount of expert judgment by the Supervisor, and a high degree of training for the team that will perform this activity.

Considering the above, this Supervisory Guide will cover the topics that are considered most important for the supervisor. It will not be a review of the chapters and principles on regulation, nor will it review the proposed rules, as many are general statements that do not involve a process of independent monitoring. This Guide will not include the supervisory process for authorizing entities and approving senior staff, for which independent guides have been developed by ASBA<sup>3</sup>. The Guide is not a manual properly speaking, as each country has its own supervisory criteria and mechanisms; therefore, the guide will only provide supervisory guidelines. Finally, it is worth noting that the guide will not review the rules one by one, but different methodologies will be defined for each chapter, which will allow supervisor to draw conclusions to assess regulatory compliance.

### IV.1. Ownership Structure

Ownership structure should be assessed to determine whether said structure is conducive to a sound development of the entity.

For this, the supervisor shall determine:

- What amount and type of information is given to the entity owners for decision-making purposes. It is essential to provide them with the information they need, in a timely manner, to allow their decision-making bodies to conduct a proper analysis.

- The owners and their participation in the ownership structure. If owners are sufficiently diversified (for example, an adequate distribution of shares in the ownership of various entities) and no single owner exercises an effective control of the entity, it is said that owners are neutral with respect to the operation of the entity (do not favor, nor harm it). Under this scenario, the controls put in place by the institution to control management should be assessed, paying close attention to the ability and independence of the Board to control Management. Another scenario would be to have a share-concentration model which is present in many countries in the region. The analysis presented below is based on a scenario of ownership concentration.
- If there is more than one owner, consider the relationship among them, in particular, with those responsible for the oversight and management of the institution.
- If there is a written document between shareholders describing the roles and responsibilities of each member, analyze it.
- The supervisor should understand each shareholder's main motivation for investing in the entity, and assess whether such reasons are consistent with the corporate strategy. It is also indicative if the entity refers to its shareholders in advertising.
- In case the institution is based in another country, supervisors must analyze the rating given to the entity by a leading rating agency.
- If the owner is a financial institution or similar, the main reason for the investment should be considered and the supervisor should assess if the reasons are consistent with the corporate strategy. It is also important to understand whether the local institution uses the same name as the foreign owner or whether it refers to its parent in institutional advertising.
- Evaluate the commitment of the owner from a technical and equity viewpoint. For this, the supervisor must determine whether:

3 ASBA, "Corporate Governance in Banking Institutions," 2009.

- ~ The owner has direct involvement in key decisions in the institution, for example, hiring key personnel, budget and business plans approval, etc.
- ~ The owner is involved in the local operation, and has sufficient knowledge to do so.
- ~ The reporting structure has a matrix form (direct reports to various bodies of the parent entity).
- ~ The owner has clear objectives and they are consistent with those set by the entity.
- ~ It has country-based staff involved in managing the entity. For this, it is important to consider know-how contribution in terms of technology, business and risk management, as well as capital contributions or liquidity in recent years, in case these were needed in the institution.
- Assess the owner's economic and financial situation, as well as his assets, including his ability to support the operations of the local entity.
- Determine the quality of the owner. The analysis should aim to conclude whether the owner will be able to back up the entity, is irrelevant, or will represent an obstacle in resolving any identified weaknesses. For this, the supervisor should consider:
  - ~ The relationship background with the supervisor, analyze whether the parent company has been responsible for the operation of the local entity or if it tends to leave the problems in the hands of the supervisor. According to the data collected, determine whether the shareholder has the ability and willingness to take on the potential or identified weaknesses.
  - ~ For this, supervisors must collect existing information on shareholders, their meetings, and the information provided to them. In case the owner is a financial institution, the supervisor should gather financial information, the opinion of the home supervisor and rating agencies. In addition, supervisors should discuss the possibility of meeting with the owner or top executives of the parent entity.

## IV.2. Board of Directors

The term Board of Directors or Board are used as synonyms.

The proper functioning of the Board is critical to the adequate functioning of the institution. In this sense, supervisors must analyze the following aspects:

### Size

While it is considered good practice for the Board to have between 5 and 15 members, the size of the Board should be adjusted to the specific needs of the entity. It must be small enough so that it can function as a cohesive team, promote discussion and effective decision making, while having a sufficient number of members to ensure the breadth and depth of knowledge, skills and experience required for effective management and operations oversight. Among other aspects, it is vital for supervisor to understand the type of entity under analysis.

Supervisors should verify that the number and composition of the Board corresponds to the size, risk, and complexity of the operations of the entity, as well as the number of Board committees. Thus, in small institutions with basic activities, the number should approach the minimum, while in large, complex institutions, the number should increase enough to incorporate different visions and concepts, as well as to cover all activities and committees.

For this, supervisors must:

- Review the statutes to analyze aspects, such as the number of directors, possible restrictions, retirement age, qualification of the Chairman and the nomination process.
- Analyze the resumes of the independent and non-executive directors.
- Conduct interviews with independent and non-executive members to understand whether they properly fulfill their roles.

### Structure

In addition to size, supervisors should analyze the composition of the Board, as an appropriate structure will be a key factor in the proper functioning of the Board. To evaluate the structure of the Board, supervisors should consider if:

- The directors as a whole complement each other's knowledge and experience covering knowledge of the business, finance, accounting, management, and auditing.
- There are influences, personal or political interests that may affect the discussion or decision-making processes of the Board or any Director.
- There is a Director or group of Directors, or a Manager or a group of managers, which have a significant influence on the Board.
- The Chairman of the Board is not the institution's Chief Executive Officer.
- The Board has a balance between executive, non-executive, and independent members. Supervisors should identify each type of Director and verify whether they meet their condition. In the case of non-executives, supervisors must verify that they are not, nor have recently been officers of the entity. In the case of Independent Directors<sup>4</sup>, supervisors shall:
  - ~ Verify whether the entity has established internal policies or criteria to define cases in which a Director is considered independent.
  - ~ Verify if Independent Directors sign a statement on their independence, and establish their independent condition in the entity's website and minutes.
  - ~ Evaluate the role played by independent directors, their participation, and the information they receive.
  - ~ Verify if there are meetings where only Independent and Non-executive Directors participate.

Board Members must demonstrate integrity and high ethical standards, coupled with a proven record of good judgment in business matters, as well as knowledge on controls and corporate governance. They should be able to question and oppose management without worrying about what this may involve. In addition, the range of skills and experience

required varies with the nature and size of the entity, and the types of activities undertaken. The skills could include knowledge in the areas of law, finance, management, human resources, accounting, auditing, credit, risk management, marketing, technology and operations, or various sectors of the economy.

In addition, supervisors must measure the level of commitment of individual members of the Board, so that each member should devote sufficient time, energy and interest to fulfill their responsibilities as a Board Member. The level of commitment may be demonstrated by members' attendance in Board and Committees meetings, and through effective and active participation in these meetings. While participation may exceptionally be through electronic means, physical presence is expected.

Supervisors must take into account Board members' external commitments. Board members must seek a balance between fulfilling their occupations outside the entity, and providing enough time and energy to actively participate in the work of the Board and its Committees. A key factor in the selection process which should be adequately documented is the time a potential Board member has available to devote to his Board responsibilities.

To carry out this review, supervisors must analyze:

- The selection procedures for Board members.
- The Board members' resumes.
- The minutes of the Board and its Committees.
- Interviews with Board members, especially with the Chairman, independent and non-executive members.

### Functioning of the Board

Once the size and structure of the Board have been evaluated, supervisor should assess its performance. For this, the following activities shall be carried out:

- Verify whether the number of sessions corresponds to the needs of the institution. A low number may indicate a lack of commitment of the Board. A high number may indicate that the Board is solving management issues. In addition, supervisors should assess whether the

<sup>4</sup> Those having sufficient professional standing, have neither have had in the recent past link to the company, the group, its shareholders or any other that may have a particular interest therein.

number of meetings is an element that weighs on the compensation of Board members.

- Supervisors should have an awareness of the preparedness of Board Members for meetings. For this, supervisors shall review the materials provided to the Board, along with additional information requested by Board members. The mechanisms used to provide information to Board members should be useful, relevant and timely, so that information is received prior to meetings and early enough to allow analysis by Board members.
- Supervisors should analyze the independence of the Board, verifying whether there are meetings where only external members (non-executive and independent) participate. This may be reinforced with external advisors in matters where the internal members are not competent.
- Determine the degree of interaction between Senior Management and Board members outside regular meetings, in order to assess the information received by the Board, and the influence of the Board on Management.
- Review the results of the entity's Corporate Governance assessment and the Board's self-evaluation.
- Assess whether there are policies and procedures to select new Board members or ratify the existing ones, and whether these establish minimum requirements to be a Director.
- Verify whether there is a succession plan for the Board, which incorporates a gradual rotation of its members.
- Verify the existence of policies and practices for re-election of Board Members, including the minimum requirements in terms of attendance, performance, and commitment. To achieve this, it is necessary to review:
  - Proceedings and regulations for the operation of the Board and Committees.
  - Policies and procedures to appoint Directors,
  - The succession plan.
  - The information received for the preparation of the Board.
  - Corporate Governance assessment performed by the entity.
  - Self-assessment of the Board.

- Interviews with the members of the Board and Senior Management.

### Responsibilities

The Board is the ultimately responsible for the institution. It delegates daily operations to Management, but does not delegate its responsibility. Its key functions can be divided into:

**Approval of the entity's strategic plan.** The Board is responsible for setting the overall vision and long-term direction of the entity, its risk philosophy and related policies.

These policies include the following:

- Approval of business objectives and related risk tolerance.
- Evaluation and approval of the entity's strategies and business plans, as well as regular monitoring and comparison of their progress. In addition, the Board should ensure these remain appropriate as the entity adapts to changes in its operating environment.
- The Board requires timely and sufficient information to evaluate and approve the recommendations of Management. Therefore, it must ensure that Management designs an adequate Management Information System for the institution and that it includes the following, as a minimum: a view on key risks and how Senior Management will control them; the results of sensitivity analyses, covering several adverse scenarios to ensure that individual and aggregate exposures remain within approved risk limits; the underlying assumptions and critical success factors; in addition to an analysis of the current and future operational environment. This leads us to the Board ensuring it has sufficient time to discuss, evaluate, and approve the entity's objectives, strategies and plans, and monitor their progress throughout the year.
- Regular monitoring of actual performance against established strategies and plans provides an opportunity for the Board to assess their suitability and confirm the effectiveness with which management implements them. The nature and frequency of the review would depend on the circumstances of the entity, including: a stable operating environment, the

nature and complexity of the strategies, the performance of the entity, as well as the experience and depth of Senior Management.

- The supervisor shall verify that the strategic plan includes key aspects, such as the entity's mission, vision, strategic objectives, and measurable goals. Supervisors must also understand and analyze the main business lines of the bank.

**Approve the policy for Comprehensive Risk Management.** The Board must approve the overall risk policy of the institution, which includes as a minimum: the definitions and limits for the risk the institution is willing to assume, models for measuring risk, the organizational structure of the risk area, and the capital level needed for the risks taken. The supervisor should ensure that Risk Management has authority, independence and adequate resources, and that it reports to the Risk Committee. Supervisors should periodically assess the level and quality of capital with regard to the level of risks being undertaken by the Board.

**Appoint, evaluate and replace Senior Management.** Supervisor should verify that the Board monitors and evaluates, based on standards, that Management's performance is consistent with the entity's strategy and long-term goals. The Board may replace Management if their performance is not as expected. In addition, the Board must appoint the Chief Financial Officer and the senior manager, such as the key business managers, the Risk Manager, the Compliance Officer and the Internal Auditor. The Board must draft a mandate and job description for the Chief Financial Officer position, as well as develop the accountability mechanisms for Senior Management. The Board should also have a succession plan that covers Board members and key management positions.

**Design of the Organizational Structure.** An appropriate organizational structure facilitates the effective supervision by the Board and promotes compliance with business objectives and strategies. The structure must provide a reference framework that facilitates: accountability, responsibilities, authorities and reporting, better communication, effective risk management, and solid Corporate Governance. When approving the organizational structure, the

Board must take into account the entity's objectives and strategies, the nature of its activities and related risks, internal control mechanisms (checks and balances), independence of the control structures, and accountability procedures.

To achieve this, supervisor must verify that:

- The Board has approved an organizational structure according to the size and complexity of the entity.
- The roles between the Board and management are clearly differentiated, where only the Chief Financial Officer and the control bodies report to the Board.
- There is a clear segregation of duties between the commercial, operational, accounting, and risk areas, ensuring that the entity understands the risks it assumed. Also, there should be no conflicts of interest within the segregation of duties, but in case these are present, there should be appropriate barriers to prevent them.
- There is a balance between the commercial and risk areas.
- There is a clear definition of roles, powers and responsibilities.
- Internal Audit reports to the Audit Committee.
- Internal Audit maintains complete independence from all operational areas, not taking any responsibility for any system.
- The Compliance Officer reports directly to the highest authority of the entity and to the respective Committee.
- The Audit Committee and other Board committees are adequately integrated and in operation.
- The management segregation of duties are consistent with the nature, size, complexity, and risk level of the institution.
- The reporting lines are clear.

In case there is a parent or controlling entity, the supervisor should evaluate the importance of the relationship between the local entity and its parent in terms of decision-making, operational autonomy, risk management, and accountability. When there is more than one international shareholder, supervisor must assess if the roles and responsibilities of dif-

ferent bodies (Board of the controlling entities, Local Board, regional or international bodies) are defined explicitly. In the case of public banks or banks owned by families, supervisor should consider to what extent the governing bodies are involved in the daily management of the institution. In this process, the Board must be satisfied that the organizational structure promotes prudent management and effective oversight of the organization and above all, is consistent with the nature, size, complexity and risk level of the entity.

### Other Responsibilities of the Board

- Approve the compliance policies.
- Approve the internal control system.
- Approve policies to monitor conflicts of interest within the entity, as well as in the economic group to which it belongs.
- Approve the Corporate Governance Code.
- Verify whether the entity reviews its governance system and adjusts its Rules, at least once a year.
- Verify if the Board has approved and promotes compliance with the Ethics Code, the Code of Conduct, the corporate values, or similar.
- Verify if the entity has procedures for the approval of operations and volumes of transactions with related parties or others that might generate conflicts of interest.
- Verify if actions are taken and penalties applied in case of deviations.

For this, supervisors must review:

- The strategic plan.
- The business plans and any follow-up on their implementation, the Board and its Committees' minutes.
- The risk policies.
- The organizational chart.
- The procedures for assessing Senior Management.
- The Corporate Governance Code, Code of Ethic, or similar.
- The procedures to assess the level and quality of capital.
- The policies and procedures to solve conflicts of interest.

- Members' sworn statement concerning links and transactions with related parties. In addition, interviews with the Directors and Senior Management will be required.

### Assessment and Training

It is expected that the Board conducts an assessment of its performance; alternatively the entity's owners can request an independent evaluation. Performance evaluations aim to compare the performance of the Board against its rules, objectives, and work plan for a specific period, and often compare the performance of the Board to the best practices of the sector. The assessment should include:

- The quality and efficiency of the performance of the Board and its members.
- The performance of the Chairman of the Board.
- The operation of the Committees.
- The deepening and deliberation of agreements recorded in Board minutes.
- A measure of the Board success in fulfilling their responsibilities; and
- A means to identify areas where changes are required to improve their effectiveness, such as changes in size, composition, use of skills, committee structure, and practices.

Board members should be evaluated individually, using a formal position description and expected compliance standards developed by non-executive members. The main objective of this review is to improve the contribution of each Board member, and develop strategies to help them improve their performance.

Based on the assessment, training plans for Board members will be developed to ensure that Board members understand the nature of business, its related risks, and have the relevant knowledge and experience on the activities conducted by the entity, or those to be performed in the future. Training should cover fiduciary duties of the directors, the entity's legal and regulatory framework, the entity's strategic direction, the economic and operating environment, and the proper functioning of the institution's corporate governance. For this, supervisors must verify that:

- The entity has a tailor-made training program for each Director, especially all the non-executive and independent ones, which includes the topics, schedules, and mechanisms to be used.
- There is a designated person in charge of defining and reviewing the training program on a regular basis.
- The Board training program has been included in the budget.

In addition, supervisors must review:

- The assessment of the Board and its Directors.
- The training plan, taking into account the profile of each Director.

### IV.3. Committees

Committees are a useful way to improve the monitoring conducted by the Board, as these allow for a deeper analysis of specific issues, providing the Board with better information and more time to discuss the most significant issues for the institution. It should be clear that the work of the committees does not relieve the Board of its responsibility and its obligation to monitor the work of the committees.

It is expected that financial institutions establish at least the following committees: Audit, Nominating and Compensation, Risk, and Corporate Governance. The Board must ensure that each Committee has operating regulations establishing its objectives, responsibilities and authority, its optimal size, and composition. The regulations must include a classification of the topics for which the Committee is authorized to act, and those for which it has authority only to analyze and recommend for Board approval. Regulations should also identify the nature and frequency of reports to the Board.

The composition of a Committee must consider the abilities, experience, attributes and level of commitment required of its Members to fulfill their responsibilities.

Supervisors should verify that each committee is formally established, and is comprised by adequate members in terms of quantity and quality. Also, supervisors must verify that the sessions have an adequate frequency and the minutes appropriately reflect the deliberations and decision-making process.

Periodically, the Board must review the effectiveness of the structure, mandate, and composition of its Committees. It should also request the rotation of Board Members in the various committees. This is expected to expand members' knowledge and introduce a different point of view to the work carried out by the committees.

For each committee, supervisors must verify that:

#### Audit Committee

- The Chairman and most of its members are non-executive directors.
- The committee fulfills its objectives, according to regulation.
- Committee members have the necessary skills to perform their duties (knowledge of accounting, auditing, finance, etc.).
- Members should rotate periodically, including the Chairman.

#### Risk Committee

- The Chairman is a non-executive member of the Board.
- The committee fulfills its objectives in accordance with the regulations.
- The Risk Manager reports to the Committee.
- The number of sessions and the topics are appropriate and allow members to evaluate key aspects of the risk system.
- Members should rotate, including the Chairman.

#### Compensation and Nominating Committee

- The Chairman and all members are non-executive members of the Board.
- They meet their objectives in accordance with the regulations.
- Members should rotate, including the Chairman.

#### Corporate Governance Committee

- Members have the adequate skills.
- The Committee meets its objectives in accordance with the regulations.
- Members should rotate, including the Chairman.

To achieve the above and for each committee, the supervisor must have access to:

- The rules and minutes of each committee,
- Current and past composition of each committee, and each member's profile.
- Interviews with committee members.

#### IV.4. Senior Management

##### Mandate

The Chief Executive Officer (CEO) is responsible for directing and overseeing the entity's operations as established by the Board. Therefore, supervisors should assess whether the nature and scope of the responsibilities delegated to the CEO are adequate to manage the entity in accordance with its nature, scope, complexity and risk profile. It should be explicit if the Board has retained operational powers, or if the CEO makes decisions that correspond to the Board. At the same time, the CEO should delegate various functions to other members of Senior Management. This delegation should be evaluated to determine whether it is sufficient to properly manage each area of the institution. In addition, supervisors must identify the control mechanisms used by the CEO to evaluate the delegated tasks. There are instances in which a Manager does not report to the CEO, but rather directly to the Board as is the case of the Internal Auditor and the Risk Manager. Supervisors should assess whether the CEO uses the management team appropriately or if he concentrates duties, and if the accountability mechanisms of the management team are adequate.

For this, supervisors should analyze:

- The organizational chart and mandates of the Chief Executive Officer and Senior Management, if any.
- Interviews with Senior Management, which are key to understand its functioning at this stage.

##### Structure

Supervisors should assess whether the organizational structure, including key reporting ratios, allow Senior Management to adequately control operations, given the nature, size, complexity, and risk profile of

the entity. The structure should facilitate effective monitoring and must promote the achievement of the entity's objectives and strategies. Business and control functions should be strictly separated.

To review the above, supervisors will review the organizational chart and verify its proper implementation.

##### Committees

Supervisors should assess the extent to which Senior Management uses committees to oversee the management of activities and its related risks. Committees can be an efficient means to oversee operations, but their effectiveness depends on the committees' structure and mandates being aligned to the entity's strategy, activities and risk profile. Committee members should collectively possess the appropriate skills and experience to conduct their oversight duties, while Senior Management has the responsibility to clearly define the committees' objectives and specify under which situations the committee has the authority to act or to solely make recommendations. Supervisors should assess the extent to which the mandates are communicated throughout the organization, and whether these are reviewed to ensure that they remain relevant to the entity's objectives and strategies.

##### Profiles

Supervisors should assess whether senior management has the qualifications, knowledge, skills and experience to fulfill their duties. In particular, managers responsible for critical areas should be evaluated in terms of their experience in other entities or in crisis situations. Supervisors should also evaluate:

- Whether Management has knowledge and experience in their specific area.
- If they have an appropriate background conduct.
- If decisions are made based on a comprehensive risk-return analysis and not based on commercial impulses.
- If the business plan and the annual budget are designed and presented to the Board for approval.

- If compliance with the plan is monitored and deviations analyzed.
- If authority limits are understood and respected.
- If there is a clear commitment with internal control.
- If the Board is provided with sufficient and timely information on the implementation of the strategic plan.

Entities must have a succession plan for all the key positions at the management level.

At this stage supervisors should:

- Obtain the profile of Senior Managers.
- Analyze the information provided to the Board.
- Analyze the succession plan.
- Conduct interviews with Senior Management.

### Risk Management

As stated in the chapter on regulation, institutions must have a risk management function with sufficient authority, independence, hierarchy and necessary resources. Supervisors should verify aspects related to formal and operational independence. Therefore, the Risk Manager is part of Senior Management, but has direct access to the Board. In addition, the Risk Manager provides timely, complete and comprehensible information to the Board and the Risk Committee, allowing them to understand the entity's risk profile. Also, supervisors must assess if the Risk Management function has appropriate human and technological resources, and physical space to exercise its duties. Supervisor shall verify that staff has the knowledge and experience to analyze the various risks, as well as to determine whether the entity's structure allows for the implementation of a comprehensive risk management system. In addition, supervisors should verify that sufficient mechanisms have been designed to identify, measure, monitor, and control the risks the institution is exposed to, including manuals, procedures and their communication to the entity. If discrepancies arise between the business and risk areas, these must be adequately documented.

To review the above, supervisor will have to:

- Analyze the organizational chart of the institution.
- Review the minutes of the risk committee.
- Analyze the budget.
- Form an opinion on the risk management system of the institution.
- Conduct interviews with the Risk Manager and the Directors in charge of overseeing risk management.

### Compliance Function

Supervisors shall verify the adequate performance of the compliance function. It must report to the highest level and have access to the Board. Supervisors should discuss the institution's Corporate Governance Code, its communication and application in the institution. In addition, supervisor shall analyze if the function has independence and sufficient resources for its proper performance, including verification of control processes and reporting to the Board.

For this, supervisors must:

- Analyze the Corporate Governance Code.
- Review the work conducted by the team in charge of this function.
- Compare the reports provided to the Board.
- Conduct interviews with the staff in charge of risk management and Directors.
- Ensure that the institution implements corrective measures, if deviations are found.

### Culture of Control

Supervisors should verify the culture of control in the institution, through reports on the control system, how the culture is communicated throughout the entity, and the potential failures and irregularities. In addition, supervisors shall review the procedures to manage conflicts of interest and operations with officers that own companies related to the controls or to the institution.

For this, supervisors should review the procedures and reports from the internal and external auditors.

### Management Information System

Management should pay special attention to maintaining a consistent approach for the development, use, and ongoing review of the entity's management information systems.

This system is used for different purposes at the management level. On one hand, it must inform long-term decisions, and determine strategic goals and objectives. On the other, it includes systems used in daily operations to monitor the entity's activities. In addition, Management uses Management Information System to measure performance, prepare budgets, manage resources, and help the entity meet regulatory requirements.

To fulfill these purposes, the entity must have a planning process that takes into account the system requirements, considering both tactic and strategic perspectives. The Management Information System is also an essential component in the entity's risk management function, and should be used to identify, measure, limit, monitor and control risks assumed by the entity.

For the management information system to operate effectively as a system of interaction and interdependence between management and staff, it is necessary to be assured that it complies with the characteristics defined in the regulation.

This tool is essential for the entity's management. Therefore, supervisors must analyze:

- The adequacy and relevance of the information provided to Senior Management (on a consolidated basis).
- If the system includes adequate and complete financial, operational, and compliance information.
- If it includes information on relevant external events that might influence the decisions made.
- Its usefulness for control management (comparison with budgets, projections, and plans, as well as if they include all the relevant activities, etc.)
- The system's flexibility to allow for greater disaggregation levels.
- The general risks the System may be posing, taking into account the characteristics of the entity in terms of volume and complexity of operations.

For this, supervisors should:

- Analyze the management information system.
- Review the internal auditor's reports on the system.
- Conduct interviews with Management and Directors on the quality of the information they receive.

### IV.5. Control Functions

#### Internal Audit

Supervisors must determine whether the Board has established an Internal Audit area, which is adequate to the activities and risk profile of the entity, so that it:

- Adequately monitors the entity's Internal Control and Comprehensive Risk Management systems.
- Monitors the adequate functioning of Corporate Governance.
- It is independent and objective, its staff duly qualified, and it has the necessary resources to perform its duties.
- Adequately reviews and conducts testing on information systems.
- Appropriately documents evidence, findings, and corrective actions.
- Verifies and reviews management's actions to overcome identified weaknesses.
- Maintains fluent and permanent communication with the Audit Committee and/or the Board.

Also, supervisors must determine whether the Internal Audit area has:

- A statute or mission establishing the purpose of the Audit function, its organization, authority, and responsibility.
- An audit plan approved by the Board, covering the area's goals, schedules, human resources, and reporting systems, and if applicable, its financial budget.
- A policy and procedures manual for the auditing work, and the assessment of risk and internal controls. This manual should be approved by the Audit Committee or the Board, and it must establish the audit function's

authority and responsibilities, as well as the scope and frequency of their activities.

- A program for professional development and training.
- A quality control program for the work conducted by the internal audit function.

Supervisors should verify if management takes timely, corrective actions with regard to the weaknesses identified by internal audit reports, and whether these are reported to the Board. In addition, supervisor shall determine if identified weaknesses are being documented, including dates and adopted corrective actions.

Another important aspect to evaluate is the independence and competence of the internal audit function. For this, supervisors must evaluate the ability of internal audit staff, assessing the level of education, relevant work experience, and background. If there is personnel who has been working for the entity for many years, supervisors should assess the extent to which this might impair their independence. Supervisors shall assess the team's expertise, primarily in terms of information systems and a training plan should be studied for the area. For the purpose of organizational independence, supervisors must verify that the Internal Audit function reports directly to the Board, and does not perform tasks that may be incompatible with their main function. The Board should also establish their remuneration. Also, supervisors should consider whether there are family ties between the internal audit staff and the rest of the institution.

Review of the Internal Audit program. Supervisors should analyze the program, making sure that all areas are audited during the various cycles. Also, supervisors should consider whether the annual plan covers the critical cycles, as determined by the risk assessment carried out by the institution. It is expected that the Board, through the Audit Committee, periodically reviews the scope of the work conducted by Internal Audit. If critical cycles are not considered in the annual plan, supervisors may consider this as an indication of lack of ability or experience in the Internal Audit staff or problems of independence and objectivity.

If there are deviations to the approved plan, the entity must investigate them and assign to implement the plan. In particular, supervisors must verify that Internal Audit includes as part of its procedures, the revision of processes to generate of information (preparation and presentation in timely and adequate manner) for the Supervisor and the Management Information System. Supervisors shall analyze reports provided to the Audit Committee, as well as follow-up reports to determine whether there are restrictions to the work of the Internal Audit function, which are imposed by management through budget or work schedule restrictions.

For this supervisors must:

- Study the minutes of the Audit Committee and the reports the Committee prepares.
- Analyze the organizational chart.
- Review the operations manual and study the personnel resumes.
- Compare the Internal Auditor's reports and working papers.
- Hold interviews with the Internal Auditor, audit officials, and members of the Audit Committee, and Managers who have been audited.

### External Auditor

Supervisors must assess the Board's commitment to comply with current regulations regarding the external audit function, determining whether the commitment focuses on meeting the bare minimum requirements or effectively meeting the objectives of the regulation. For this, supervisor will need to determine who is involved in awarding the External Auditors' contract, which elements were taken into account, and if there is a discussion process on the contract. In relation to the audit work, supervisors must assess whether there is a monitoring mechanism to ensure the approved plan is implemented. Supervisors should verify that the reports are received in a timely manner and are analyzed and discussed by the Audit Committee, ensuring that management takes timely corrective actions to correct any weaknesses found.

A second aspect for review is the independence and competence of the External Auditor and his team. For this, supervisors must determine if:

- The Board, the Audit Committee or Management have discussed other consulting services with the External Auditor, such as accounting registration services or other services related to financial statements; design and implementation of the accounting information system; approach to risks, legal services, human resources or any other services that may compromise the external auditor's independence.
- The External Auditor has been hired by the entity to serve as a senior advisor or in any other capacity which provides him with management responsibilities.
- A relative of the External Auditor or a member of the external auditor's firm has previously worked for the entity.
- A former director or employee is currently working for the External Auditor.
- There are direct or indirect financial interest and/or business relationships between the external auditor and the entity's directors or employees with decision-making power.
- There have been restrictions on the work of the External Auditor imposed by the entity, whether budgetary or related to the work schedule.
- The External Auditor has internal rules to ensure compliance with the International Standards on Auditing (ISAs) as regards to independence, skills, professional competence, and quality control of the work conducted.
- Since the last assessment, the institution has changed its External Auditing firm, and where appropriate, the reasons for doing so. If there has been a change in the partner signing the reports, supervisors shall investigate the causes of such change.
- The contract establishes the scope, fees, work schedule, deliverables, and scope limitations.
- Discrepancies in the reports, observations, limitations or disclaimers that require a deeper supervisory work.

- The working papers have sufficient analysis on audit processes and show reasonableness in reviewing the entity's main business operations.
- The auditing staff's experience, knowledge of banking operations, and auditing techniques for financial institutions and in specialized areas is adequate.

For this, supervisors must:

- Review the minutes of the Audit Committee.
- Analyze the contract signed by the External Auditor and the institution.
- Study the reports submitted by Auditors, and their respective working papers.
- Verify the characteristics of the External Auditor's staff.
- Conduct interviews with the External Auditor and members of the Audit Committee.

#### IV.6. Compensation

The supervisor should verify the compensation system, especially areas that seek to develop different incentives for employees. For this, supervisors must determine whether the Board has adopted a compensation and incentives policy.

To meet this objective, supervisors should review:

- If the Board has approved a policy on remuneration and incentives for all staff (including Senior Management). The policy should not encourage excessive risk-taking and should primarily apply to staff taking risks, individually and collectively (e.g. credit analysts). The policy must be aligned with the entity's goals, objectives and risk level.
- That remuneration policy is reviewed annually, through an independent review from management. The Board's review must ensure that remuneration and incentive policies cover all key areas of the institution, and that these are in line with the entity's goals, objectives and risk level.
- That the Internal Audit function verifies the entity's compliance with incentive policies and that these policies should be included as part of the Annual Audit Plan. Also, the entity may consider a review conducted by the External Auditor.

- That a Compensation Committee has been created, its duties have been defined, it reports directly to the Board, and it provides independent and professional judgment on the entity's remuneration and incentive policies. In addition, supervisors should verify that the Risk Committee has participated in the design and revision of the compensation system.
- That the variable remuneration of the Board and senior management is associated with the entity's long-term risk position, rather than promoting a short-term approach.
- That the remuneration and incentives structure of personnel in the entity's Control Areas should not compromise its independence or create conflicts of interest. Their remuneration and incentives should be based on their own area's objectives and is not determined by the performance of the business areas they review. The performance factors used should not be linked to profit or revenue, nor be related to business performance.
- The remuneration of the business areas is adjusted for the risks they take. The entity must consider all material risks (credit, market, liquidity, operational, and other difficult to measure, such as reputational risk).
- That remuneration expenses do not represent an important cash outflow that may hurt the entity's solvency.
- That the documents formalizing the relationship between members of the Board and Senior Management (Executive Officer, Risk Manager, Audit Manager, and business line managers) with the entity, include clauses such as "golden parachutes" to avoid that these employees being fired in case of mergers or acquisitions, or agreements exist that ensure bonuses, regardless of the performance of the company.
- That contracts include clauses for deferred payments for management and other employees whose decisions have a material impact on the risk exposure of the entity, in order to ensure that a significant proportion of variable remuneration is paid according to a deferred payment agreement over time. Deferral periods typically must not be less than three years, but will depend on the nature of the business line. In addition, the variable remuneration portion should increase significantly according to the level of responsibility.
  - For this, supervisors must review the minutes of the Compensation Committee, the approved policies, their application, and the risk assessment taking into account the following elements:
    - The combination of cash and other elements included in the compensation system for senior staff.
    - Each individual's compensation history and that of others in the institution.
    - The financial condition of the institution.
    - Compensation practices in comparable institutions.
    - The total cost of retirement of senior staff.



## V. IMPLEMENTATION GUIDE

The implementation guide introduces the necessary conditions and the process to adequately implement Corporate Governance regulatory and supervisory practices in financial institutions. The guide is organized in three sections: (i) preconditions; (ii) the steps towards an adequate regulation; and (iii) the mechanisms for an effective supervision.

### Preconditions

An adequate Corporate Governance regulation and supervision requires that the preconditions presented in Chapter II are in place. Thus, the law should define the basic aspects allowing the supervisor to have the authority and the support needed to supervise corporate governance with a risk-based approach. The main purpose is for the supervisor to take preventive and proactive actions to avoid undue risks or breaches by the supervised entity, which should have enough capital to cover the risks it assumed. It is worth noting that the entity is responsible for properly managing risks, which mainly depends on its own Corporate Governance. In this sense, the first steps in the implementation process should include:

- a) Reviewing the legal framework to confirm that the law establishes basic definitions on Corporate Governance.
- b) Verify that the law gives the Supervisor sufficient powers to regulate and supervise Corporate Governance on an ongoing basis, as well as provides adequate protection with respect to the measures and actions taken.
- c) Implement a risk oversight process that incorporates the evaluation of the entity's corporate governance.

- d) Conduct sufficient training, allowing supervisors to provide expert judgment on the subject.

### Regulation

Adequate regulation is essential for the development of a structure to supervise Corporate Governance, and it should include the characteristics introduced in Chapter III, but in all cases should take into account the characteristics of local institutions to issue regulation. In addition, regulation must cover all types of financial intermediaries, regardless of size, complexity, nature and level of risks. Regulation is useful in discussing Corporate Governance in the financial system. It is good practice for this regulation to be presented in a single norm, which provides a global overview of the topic for regulators, entities and related parties. To accomplish this, one should:

- a) Analyze the current regulatory framework in the country (law or regulation) to compare it with the regulatory principles. Based on the analysis, determine the regulations that should be issued.
- b) Review whether the regulation to be issued is consistent with the characteristics of the financial system (type of owners, types of entities) and can be applied to different types of institutions in accordance to their nature, size, complexity and risk level.
- c) Compile all norms regarding Corporate Governance in financial institutions in a single regulatory body.
- d) Allow time for the dissemination and discussion of regulation, considering the observations raised at the time of its approval. Once approved, provide time for institutions to effectively implement the norm. In addition, regulation should be communicated and training designed for supervisors and the financial system in general.

### Supervision

The supervisory process for Corporate Governance regulation is very important, but also complex. It depends on the overall design of the supervisory process, but in this topic in particular

supervisors should apply their expert judgment to assess the appropriateness of corporate governance. This leads to the need for a significant amount of training in this subject field.

To design a value-added supervisory process, it is necessary to:

- a) Design a procedure to supervise corporate governance that considers the principles enunciated in Chapter IV, and integrate this procedure as part of the overall supervisory process defined by each country. The procedure should be designed based on the expert judgment of the supervisor, who is responsible for identifying violations to the regulatory principles. At all times, the process will aim to determine the underlying problem or its cause, going beyond the symptoms or findings. As an example, when reviewing debtors' files that do not have enough information or analysis,
- b) Communicate and effectively train supervisors to be familiar with the designed process.
- c) Prior to its implementation, it is recommended to conduct a pilot test for the supervisory process, covering a significant number of institutions and with the information available at the time.
- d) The assessment of Corporate Governance may have its own rating or be part of the overall risk assessment of the entity, depending on how the supervisory approach in each country. In addition, Corporate Governance may be rated independently or as a part of the risk rating.

# VI. CORPORATE GOVERNANCE IN STATE-OWNED BANKS

## Introduction

State-owned banks have a historical tradition in Latin America, with significant presence in the region. While their importance has declined in recent times, a recent document published by the Development Bank of Latin America (CAF)<sup>5</sup> highlights an increase in the participation of these institutions since 2009.

The CAF's document covers State-owned banks that focus on development banking and the importance of their Corporate Governance for their effective operation. First, the paper refers to how property rights are not clearly established for these banks, since Secretaries or other government authorities have a low specialization to exercise these rights. The lack of transparency about who and how property rights are exercised may exacerbate agency problems between shareholders, the board and senior management. In addition, these banks may face a potential conflict between their social objectives and the economic performance of their capital. Finally, the lack of controls may turn these institutions into a vehicle for political patronage.

In 2005, the Organization for Economic Cooperation and Development (OECD) published a paper on Corporate Governance in State-owned entities<sup>6</sup>, which suggested that the greatest challenge is finding the right balance between the State's responsibilities and its role as owner. This conflict of interest is evident in the election of the Board, the

political interference in managing the entity, and according to the OECD, public companies face different Governance challenges to those faced by the rest of companies. Difficulties in Corporate Governance arise from the accountability mechanism of these entities, since it involves a complex set of agents (Management, the Board, State enterprises, Secretaries, the government), without a clear identification of the principal, among these parties.

From these and other similar analyses, we may conclude that corporate governance of State-owned banks requires special attention to identify and make proposal on their Corporate Governance. In 2011, ASBA conducted a survey on this topic and found that there are opportunities to improve corporate governance of State-owned banks, which are highlighted below:

## Areas for Improvement

The following paragraphs highlight Corporate Governance topics in State-owned banks in the region that can be implemented to improve their operation. This description is made on the understanding that all regulatory principles outlined in Chapter III apply to State-owned banks, and this section focuses only on topics that have been added given the special features of these banks. Thus, it is appropriate to highlight the following:

- First, State-owned banks, as financial intermediaries, must meet the same regulatory and supervisory requirements as private banks.
- The Supervisor must have equal powers of regulation and supervision for both State-owned and private banks, including punitive authority.
- It is essential that the role of the owner be satisfied, not only in relation to budgets and regulatory compliance, but also with respect to meeting a strategic plan with long-term definitions and carrying out a follow-up on the implementation of such plan.
- In relation to the Board, there are several aspects that are worth noting:
  - ~ **Directors' Profile.** It is essential that Directors meet the appropriate profile, so that if the bank were private, they would be elected for the position. Their professional

5 CAF, "Financial Services for Development: Promoting Financial Access in Latin America", 2011.

6 OECD, "Guidelines on Corporate Governance of State-Owned Enterprises" 2005.

skills, integrity, experience and dedication should be highlighted. In addition, Directors should not have an explicit conflict of interest with the bank. In relation to the skills and experience, Directors must not be solely analyzed on an individual basis, but also as a whole.

- ~ **Mechanism for Election.** The selection process mainly includes the political system (for example, it can be a proposal by the President, the Executive branch, or Congress). To mitigate the potential agency problem that arises from this type of election process, and to achieve continuity in the operation of the bank, as well as to ensure Directors have the right skills, it is recommended that the election period does not match the presidential election or the government's period in office. In addition, a mechanism that would optimize the process would be the requirement that prior to the appointment by the competent political body, the Supervisor should provide a non-objection.
- ~ **Training.** Board members should establish and annual training plan to help them meet the institution's objectives and to exercise an effective control of Management.
- **Management.** It is vital that these institutions have a professional management team with no connections to the political system. It must be elected according to transparency mechanisms and professional criteria. Its mandate must not be related to the election cycle and should

establish a clear separation between the Management functions and the Board. The law can be used as a mechanism to clarify the roles and responsibilities of each.

- **Objectives.** These institutions often have both commercial and social objectives. Social objectives must be explicit and defined by law or the body that represents the owner. The two types of objectives often come into conflict, which is why governance mechanisms must be defined to solve such conflicts. These mechanisms usually include Board decisions, which may be part of the entity's strategic and business plan. These objectives should be included in strategic and business plans, as well as monitored and measured. In addition, in all cases, mechanisms must be found to finance the various social objectives other than the institution's deposit accounts (usually subsidies granted by the Government itself).
- **Accountability.** One way to improve corporate governance mechanisms in these institutions is to develop appropriate accountability mechanisms. There should be a Government body that acts as a representative of shareholders, and requires the Board to be accountable not only for budgetary, legal or strategic matters, but also for the compliance with commercial and social objectives. The mechanisms for public accountability support the Board's transparency and alignment.

The topics outlined require special attention in this type of institutions, but these institutions must also meet the aspects described in the regulatory framework presented in Chapter III.

## REGIONAL ASSESSMENT AND MAJOR ADVANCES IN THE DEVELOPMENT OF CORPORATE GOVERNANCE BEST PRACTICES

### Regional Assessment

In order to identify the regional situation regarding the regulation and supervision of the Corporate Governance, ASBA conducted a survey in 36 associate member countries and obtained 22 responses<sup>7</sup>. The following paragraphs describe the results and main conclusions of the survey

#### a. Legal Framework.

From the surveyed countries, 21 countries stated having a legal framework for commercial companies. In particular, the legal form allowed for financial intermediaries in all countries is that of a corporation, with registered shares. In addition, other accepted legal forms include: cooperatives, foreign bank branches, and State-owned banks. In four surveyed countries, banks with bearer shares are allowed.

In terms of shareholder rights, it was observed that a number of them are considered basic and defined by law, these include the right to:

- Participate in shareholder Assemblies and exercise their right to vote.
- Proportional property of the business.
- Terminate contracts in cases specified by law.
- Preferential right to acquire shares in the entity.
- Transfer their proportional property to third parties.
- Oversee management, review documents and receive information.

- Call for an Assembly and propose Directors.
- Exercise the powers of termination in cases specified by law.
- Profit sharing.
- Claim and exercise legal action over fraudulent acts.

In relation to conflicts of interest, half of the surveyed countries indicated they do not regulate the legal obligation for shareholder to refrain from making decisions in case of a conflict of interest. In such cases, the Assembly has the power to appoint, remunerate, and dismiss Directors and Trustees (if any) to solve the conflict.

With regard to the powers of the Board, most legal frameworks in the region establish the following obligations:

- Determine the organizational structure.
- Oversight of management.
- Elect, evaluate, remunerate and dismiss management.
- Determine the structure for risk management and internal control.
- Ensure the solvency and liquidity of the institution

Board responsibilities, include: the duty of loyalty and care, to avoid conflicts of interest, compliance with legal obligations, confidentiality, cooperation with auditors and supervisors, and the obligation to provide accurate information to stakeholders, at their request.

Finally, in the vast majority of surveyed legal frameworks (21), the relevant legislation has a special section on the liquidation of banks.

As noted, the legal frameworks in the region –in general- cover the basic aspects to develop an

<sup>7</sup> Belice, Bolivia, Brasil, British Virgin Island, Great Cayman, Chile, Costa Rica, Ecuador, El Salvador, Spain, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Dominican Republic, Trinidad and Tobago, Uruguay and the United States of America.

adequate Corporate Governance. It is necessary to emphasize that shareholders' knowledge and the obligation to declare any conflicts of interest they may have are critical to achieve a strong Corporate Governance framework.

**b. Capabilities and Competencies of the Supervisory Agencies.**

The survey results show that a vast majority of countries (95%) have the power to issue Corporate Governance regulation, and to sanction senior management (in case of a legal and/or regulatory violation). In addition, in 71% of the surveyed countries the Supervisor has the power to require the removal of senior staff. The following chart summarizes the supervisory powers discussed above:

| Supervisory Power  | % of Supervisors in the region |
|--|--------------------------------|
| Issue Corporate Governance standards                           | 95%                            |
| Give instructions on the operation of the Board and Management | 100%                           |
| Sanction the senior staff                                      | 95%                            |
| Substitution of the senior staff                               | 71%                            |

In terms of experience, a significant number of surveyed supervisory authorities have an adequate experience in Corporate Governance; however, in terms of training in this subject the situation is mixed. In consequence, greater efforts should be geared towards providing supervisors, in all countries, access to uniform and high-quality training on Corporate Governance and Risk Management.

For example, the aforementioned can raise awareness about the advantages of having a legal framework oriented towards best practices in Corporate Governance, which (for example) penalizes or allows the supervisor to remove or substitute senior staff.

**c. Authorization of Senior Management and Banking Licenses.**

In terms of the authorization process for financial institutions, the survey shows that the topics evaluated are: the ownership structure; the organizational structure, in particular the one related to internal control and its bodies; risk policies; strategic and business planning; senior management's capabilities, experience and background; and the information systems.

The supervisor has the power to deny license authorizations when shareholders concentrate a significant portion of capital. In all cases, supervisor evaluate shareholders' suitability, solvency, background, and abilities, as well as all companies to which they are related; and in the case of foreign entities, supervisors evaluate the information shared by the home supervisor.

In terms of senior management, only 15 countries have the power to authorize senior management in financial institutions. Some have a requirement when institutions are initially opened, but do not maintain the power through the life of the entity. Several countries do not have a requirement to evaluate senior management (between 12 and 13 countries depending on whether they are Directors or Managers), nor do they have training plans for them. These three issues, along with the need for supervisory powers to require the replacement of senior management are aspects worth noting in this section.

**d. Regulatory Framework.**

Nineteen countries in the region have a regulation on Corporate Governance. In some countries, regulation is distributed in various legislation chapters, while in others specific chapters are developed on the subject. In several countries, Corporate Governance regulation is established as a law, requiring compliance with the norm; but at the same time, making it less flexible. It is recommended, as a best practice, to develop certain chapters that provide a comprehensive understanding of supervisors' requirements on Corporate Governance.

As for the design of regulation, there is a larger number of countries where Corporate Governance requirements are found in the form of a regulatory framework (e.g. with details and descriptions on how to comply), than those that establish it as a principles or standard (e.g. as a general statement to be implemented by the institution).

| Where is the regulation on Corporate Governance found? |    |
|--|----|
| Regulatory Framework                                   | 13 |
| Law  | 7  |
| Distributed in different standards                     | 3  |
| Other status   | 1  |

In relation to shareholders, 17 countries impose requirements on controlling shareholders, and 14 countries define the information to which shareholders should have access to. However, very few countries have a requirement on establishing an investors' relations office (5 countries).

In all countries, there are regulatory requirements on the operation and main powers of the Board. In 13 countries, there is definition of Non-executive and Independent Director.

In addition, the regulatory framework requires banks to design the following: Code of Ethics, Code of Conduct, and a Corporate Governance Code.

In terms of committees, all countries require financial institutions to have an Audit Committee, and 19 countries require a Risk Committee. On a smaller scale, countries require a Compensation Committee, Compliance and Nomination Committees.

In the vast majority of cases (20 countries), there is regulation regarding related parties, which restricts or prohibits operations with these parties. Some of the restrictions include: the prohibition or limitation of granting loans; the obligation to conduct transactions based on market conditions; the limitation of dividend distribution; and, the power to reject an authorization in cases where this would complicate the supervisory process. In addition,

there is regulation on management's capabilities, competencies and background; and in most countries, there are norms on the operation of Internal Audit.

#### e. Compensation System.

In terms of compensation, the survey reveals the need to advance in establishing regulation on the subject. In this sense, few countries have norms on the entity's compensations systems, and even fewer require public disclosure of the basic aspects of this system. However, a growing number of agencies are conducting monitoring processes on the topic.

| Compensation System (number of countries)                       |    |
|---|----|
| Regulation exists on this system                                | 9  |
| The main aspects of the system are public                       | 5  |
| Systems have some relation with the institution's level of risk | 10 |
| These systems are monitored                                     | 12 |

#### f. Supervisory Process.

In 20 surveyed countries, supervisory processes are performed to verify compliance with Corporate Governance laws and standards. As part of the process, supervisors: review Board minutes; conduct interviews with senior management; review the entity's business plans, as well as the practices and effectiveness of the Board and its Committees; review risk polices; evaluate the work conducted by the Internal and External Auditors; assess the operation of non-executive and independent directors; and ensures an adequate balance of interests. In all cases, supervisors conduct an evaluation of the entity's Corporate Governance. In addition, in seven countries other agents also perform this type of assessment (for example, the securities commission). Also, in 21 countries supervisors take into account the Corporate Governance analysis to draw conclusions on the entity's risk management system; while in 12 countries, supervisors provide a rating on the entity's Corporate Governance.

### g. Transparency.

In terms of information disclosure, there are various situations. Some countries publish financial information on a monthly or quarterly basis, while others do it annually. Regarding risk, Corporate Governance, and compensation policies, the number of countries requiring public disclosure are still low (8, 12, and 7 respectively).

### h. Conglomerates.

While 21 supervisory agencies require financial institutions to report the economic groups to which they belong, only 13 perform Corporate Governance assessments on the conglomerate.

As noted from the above, the region reasonably complies with establishing a Corporate Governance regulatory framework and supervisory process for financial institutions. However, the survey helped identify the following topics, which require special attention to improve the regulation and supervision of Corporate Governance in the region:

- **Legal authority:** efforts should be made in requiring entity's to identify their controlling shareholders and in shareholders' obligation to declare conflicts of interest.
- **Supervisory powers:** it is necessary to provide supervisors with the power to remove or sanction senior management, even in cases when – in the supervisor's opinion – there is negligence or recklessness that may threaten the financial institution.
- **Training:** supervisors should have the necessary knowledge to conduct their work, in terms of Corporate Governance and risk regulation and supervision. In the first instance,

supervisors should have a basic understanding of the most common and widespread practices on Corporate Governance, as well as allow for an updated knowledge on recent trends as these are developed globally. In addition, financial institutions should be required to establish training plans for their personnel, as well as request performance evaluations.

- **Authorization process:** there is a need to homogenize the powers of authorization of the senior staff by the supervisor. On this specific topics, ASBA published a guideline in 2009 entitled "Authorization of Banking Licenses" which is a reference in the field.
- **Regulation:** it is necessary to make a greater effort to increase the flexibility of regulation, so that the Corporate Governance regulatory framework is consistent and applicable to all types of institutions, regardless of their size, nature, risk level, and complexity.
- **Compensation systems:** further progress in regulatory schemes, transparency, and supervisory processes are needed to limit shareholders' compensation when certain events, both internal and external, take place.
- **Supervision:** the survey reveals that adequate supervisory processes should be developed for Corporate Governance, and these should be integrated into the overall supervisory process of the entity.
- **Transparency:** efforts should be made to increase transparency in the institution's Corporate Governance, risk management, and compensation schemes.

## ADVANCES IN THE DEVELOPMENT OF BEST PRACTICES

After the recent international financial crisis, several international organisms and countries have started promoting Corporate Governance in financial institutions. The following presents a summary of best practices, which along with the regional assessment, are the basis for this document:

- **Board:** the Board is primarily responsible for the proper management of the institution, including the definition of its risk appetite and an adequate Corporate Governance framework. It is essential that there is an adequate balance between the abilities, experience and independence of its members, as well as a training plan covering the entity's business activities. Given its importance, a self-assessment mechanism should be developed to evaluate Corporate Governance within the Board and for the institution as a whole, where the independence of the reviewing team is essential. In addition, supervisors should consider how long have independent directors held office under the same Chairman and CEO. In addition, the participation of Board members should be clearly defined and documented to ensure decision-making processes are carried out according to sound Corporate Governance practices.
- **Board Committees:** the essential committees include: Audit, Risk, as well as Compensation and Nomination. Their Chairmen must be independent members and its members should rotate, in particular their Chairmen.
- **Chairman of the Board:** the Chairman must combine knowledge, experience and leadership skills. It is recommended that elections are periodic to enable the Chairman to continue in office, as long as he obtains favorable results in his performance evaluations. It is a good practice for the CEO and the Chairman of the Board not to be the same person. In case these positions are held by the same person, the entity should take steps to mitigate the concentration of duties. The Chairman should play an important role in promoting an active participation of independent Board members, as well as distributing information on the institution in a timely manner.
- **Conflicts of interest:** emphasis should be placed on the obligation of shareholders, Board members and the CEO must disclose potential conflicts of interest. At the same time, the entity should establish mechanisms to prevent, and if necessary solve these conflicts.
- **Risk Manager:** the risk manager must have sufficient authority, hierarchy, independence, resources, and access to the Board for decision-making. It must be an independent line of business and have no other related duties that may impede the proper performance of their activities. The risk function must be commensurate with the entity's size and complexity, including its analysis of quantitative and qualitative elements. In addition, the risk analysis should be applied to new products, and the entity must be aware of mergers and acquisitions that, if not properly evaluated, may trigger an increase in risk exposure. Finally, Risk Management compensation should be determined by the Board, avoiding incentives for an excessive risk taking behavior.
- **Compensation systems:** several principles have been established on compensation systems, looking for designs that align the interests of managers and shareholders. Therefore, special attention was given to compensation systems being based on the entity's long-term results. As a result, it is necessary for non-executive directors to participate in the design and review of the system. Also, care should be taken in maintaining a balance between fixed and variable compensation, as well as being consistent with sound practices under either high or low cycles of the entity. Finally, the transparency of the system should be promoted.
- **Conglomerates:** in the case of conglomerates, the controlling or parent entity must have the responsibility of implementing a sound Corporate Governance framework in the entire

group. For this purpose, the controlling entity must ensure the proper distribution of capital in accordance to each unit's risk. Corporate Governance at the group level may be different from that of each unit; therefore, supervisors, during their review process, should pay attention to the potential differences between Corporate Governance at the controlling entity and the other units that make up the conglomerate.

- **Transparency:** institutions should be sufficiently transparent to shareholders, depositors and other related parties. Information disclosure should cover not only financial information, but also risk, Corporate Governance, and compensation policies, among others.
- **Proportionality:** Corporate Governance principles should apply to all financial intermediaries, regardless of their purpose or legal nature. In all cases, supervisors should take

into account the nature, size, complexity and risk level of the various institutions.

- **Supervision:** the supervisor must periodically evaluate the adequate operation of the financial entity's Corporate Governance framework. For this purpose, supervisors must define processes and tools to carry out on-site inspections and off-site monitoring. In particular, supervisors must pay attention to the entity's risk profile and its internal control function. As part of their duties, supervisors should define an interview process to authorize non-executive directors. These interviews should also have the participation of the entity's senior staff, which have adequate levels of experience, responsibility, and hierarchy, as well as personnel from the regulatory and supervisory authorities with a proven ability to evaluate and judge the suitability of the proposed director.

## Members of the Working Group

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**Superintendencia de Bancos e Instituciones Financieras, Chile**  
Mr. Carlos Pavez Tolosa  
(President of the Working Group)

**Banco Central Do Brasil**  
Mr. Reinaldo Busch Alves

**Superintendencia General de Entidades Financieras, Costa Rica**  
Mr. Alexander Arriola Cruz

**Eastern Caribbean Central Bank**  
Mrs. Alisa Glace

**Superintendencia del Sistema Financiero, El Salvador**  
Mr. Guillermo Rivas López

**Banco de España, Spain**  
Mr. Diego Fernández Rodríguez

**Comisión Nacional de Banca y Valores, Mexico**  
Mrs. Yearim Valles Arellano

**Superintendencia de Bancos, Panama**  
Mr. René Menéndez Sáenz

**Banco Central del Uruguay**  
Mrs. Mónica Segovia Caballero

**Superintendencia de Banca, Seguros y AFPs, Peru**  
Sr. Eduardo Flores Salazar

**Federal Deposit Insurance Corporation, United States of America**  
Sra. Araceli Nuño

## Consultant

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Mr. Jorge Ottavianelli García

## Technical Secretariat

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Ms. Pamela Afcha Mallo  
Mr. Ricardo Toranzo Gutiérrez

## General Secretariat

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**Association of Supervisors of Banks of the Americas**  
Mr. Rudy V. Araujo Medinacelli





## **MISSION**

Contribute to the strengthening of bank regulation and supervision and financial system stability in the Region by actively sharing information and disseminating knowledge; providing support and services that lead to increased technical capacity and leadership; supporting the adoption and implementation of sound supervisory practices; and promoting timely and relevant international dialogue.

## **OBJECTIVES**

- a. 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;
- b. Provide its members with a high-level discussion forum for the exchange of information, ideas, techniques, experiences and knowledge over their scope of competence;
- c. Promote and carry out research and analysis on financial regulation and supervision as well as financial stability;
- d. Organize and conduct systematic and permanent training programs as well as technical cooperation amongst its Members;
- e. Promote cooperation and exchange relationships with non-member bank supervisors, with financial standard setting institutions, with international and multilateral technical cooperation institutions, with other organizations with similar objectives and with organizations representative of the supervised entities; and
- f. In general, to carry out every activity related to its purposes.