Liaison Office to the EU
Rue Breydel 40
B-1040 Brussels (Belgium)
Phone: +32 (0)2 23 58 645
Fax: +32 (0)2 23 58 610
Email: brussels@transparency.org
http://www.transparencyinternational.eu

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Transparency International (TI) welcomes and contributes to the European Commission (EC) DG Internal Market and Services public consultation on corporate governance and remuneration policies in financial institutions:

Corporate governance is a strong bulwark against corruption in the financial sector

Corporate Governance reduces corruption

Corporate governance manages and reduces financial and non-financial (operational) risks by embedding integrity, transparency and accountability within a company. Corporate governance ensures that board members, managers, employees and shareholders direct and control the firm to provide appropriate results balanced to the interests of shareholders and other stakeholders. Further, it serves as a framework to secure investor confidence, enhance access to capital markets, promote growth and strengthen economies.

Financial Crisis highlighted failure of corporate governance

When breaches in corporate governance happen, they are a strong signal that the balance of interests represented by a good corporate governance structure is out of equilibrium or dysfunctional. Much of the indignation by the public relates to the perception that bankers, including traders, structured finance and derivatives **experts acted recklessly or negligently and served their own interests at the expense of their companies and stakeholders**. They pursued short term results and ignored or lost sight of the good governance principles which should have guided their activities. The failures, in this regard, mainly included negligence, excessive risk taking, a lack of supervision both by the authorities and the boards, a lack of stakeholder engagement and quiescent investors.

Rethinking corporate governance systems

This **ethical and professional failure was not addressed adequately by legislation or regulation** or the governance practices of the financial entities. TI considers that action needs to be taken to ensure stronger legislation and regulation allied to voluntary, internal measures to manage and mitigate financial and non-financial risk.

A major obstacle is that the existing framework of financial services presents **huge incentives to take on big risks with no individual risks on the downside**. Employees are lavishly rewarded for securing returns irrespective of whether their actions contradict company risk policy or the warnings of the risk department, safe in the knowledge that their actions face little personal risk. The well-publicised bailout of financial institutions and the dearth of criminal convictions despite widespread allegations of fraud and mismanagement in the wake of the financial crisis do nothing to reduce the appetite for excessive risk.

A rethinking of corporate governance strategy that restructures employee incentives in favour of long-term stability, highlights the important role of the risk department, and promotes personal accountability and integrity can take large steps to address this obstacle.

Transparency International believes that the **board of directors is one of the major elements of a successful corporate governance system**. The board provides oversight and takes leadership on strategic and key operational issues and is considered as having the 'duty of care' for a company by setting the 'tone at the top' and promoting a corporate governance framework that covers all levels of the organisation and types of risks.

To reinforce and operationalise this alignment, the active engagement of the board in good governance systems is essential. Given its oversight and organisational role, the board assumes responsibility over ethical policies, auditing (internal and external) standards and legal compliance systems to counter the risk of abuses. Additionally, increasing a company's commitment to corporate responsibility and sustainability initiatives — as part of overarching commitment to values and ethical standards — can build the level of business integrity needed to mitigate corruption risks. Anti-corruption laws and regulations can never provide sufficiently for detailed implementation of anti-corruption measures nor be flexible enough to meet changing circumstances and risks.

It is of fundamental importance that members of the board have a general knowledge of the working and risks and rewards of financial products and services that are offered by their institution to customers. Without such general knowledge the board is unable to adequately 'sign off' on company risk policy, yet remains ultimately accountable for failings. Auditors should report on methods to enhance this kind of accountability in their annual report.

Financial institutions touch upon every aspect of commerce and society and therefore corruption in the financial system can pose risk of severe consequences as seen in the recent financial crisis. It is of paramount importance to promote a culture of integrity and good governance at board and all levels of financial institutions. This can be achieved through soft and hard regulation as well as voluntary initiatives that engender responsible business practice, a greater appreciation and application of risk management, full knowledge of company risk policy and, above all, an embedded culture of ethical business.

Lessons learned from recent corporate governance reforms

Recent corporate governance reforms have focused on the sources of system failures and their inability to effectively mitigate the full spectrum of company risks: financial, operational and corruption. In response, companies and governments have increasingly pursued mechanisms to regulate and prevent the breakdowns that can lead to corruption by introducing independent directors to boards, separation of roles of the chair and chief executive, strengthening shareholder voting rights, providing clearer accounting standards to prevent fraud and making requiring transparency of board and executive remuneration. As the current global crisis unfolds, new areas are likely to emerge that focus increasingly on oversight and regulation of companies, board accountability, risk management and company disclosure policies (such as exposure to financial products and integrated reporting).

TRANSPARENCY INTERNATIONAL
Rue Breydel 40, B-1040 Brussels (Belgium)
Phone: +32 (0)2 23 58 645
Email: brussels@transparency.org
EC Register of Interest Representatives ID: 501222919-71

As a general rule, TI recommends corporate governance systems to:

- Provide committed and consistent leadership ('tone from the top') that makes performance with integrity the foundation of the corporation;
- Manage performance with integrity as a business process by building the integrity infrastructure (risk assessment and risk mitigation to prevent, detect and respond) into business operations;
- Reduce appetite for high-risk transactions, either by restructuring employee compensation to reward responsible, sustainable long-term performance or by prioritising the voice of risk department personnel;
- Adopt ethical policies and procedures going beyond compliance;
- Use early warning systems to monitor and counter risks;
- Foster employee and business partner awareness, knowledge and commitment through stimulating, systematic education and training;
- Secure channels are provided for employees to seek advice or voice concerns (whistle blowing) without fear of intimidation or retaliation;
- Design compensation systems so that management and employees are paid not just for performance, but for performance with integrity

The link between corporate governance and anti-corruption

The processes that characterise strong corporate governance systems align in many respects with the key elements for countering bribery that have been outlined in the *Business Principles for Countering Bribery (BPCB)*[1], *an anti-bribery code developed though a multi-stakeholder process led by TI,* as well as their suite of tools. Anti-corruption principles are a vital part of effective corporate governance because they underline the need to take seriously the long-term viability and **interests of the company and its stakeholders ahead of the interest of the board or management in generating short term gains or inflated remuneration and bonuses** - in short, the financial entities must commit to and implement strong ethical principles and responsible management of their businesses.

Other Transparency International answers to some of the EC green paper questions on corporate governance that are of most concern to creating stronger ethical business standards:

1.3 European Commission: Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

TI believes that recruitment policies should reflect the enterprise's commitment to effective and general good governance standards. Several members of Board should have a strong risk management background in order to make clear that the ability to manage risks is of paramount importance to the company and is a hallmark of strong leadership skills. Recruitment should seek more non-executive and

[1] Transparency International website: http://www.transparency.org/global_priorities/private_sector

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independent members on boards in order to tackle conflicts of interest related to internal controls, financial reporting and executive compensation.

1.5 European Commission: Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

TI believes that the board should consider whether to commission external verification or assurance of its performance. Regular self- and external assessment can define whether new profiles are required in the board to cope with new products or circumstances**.** This external verification should be extended to risk-related financial information, non-financial risk management policies and systems.
Where such external verification or assurance is conducted, the board or equivalent body should consider publicly disclosing that an external review has taken place, together with the related verification or assurance opinion, to the general meeting, supervisory authorities and the general public (included in their corporate social responsibility disclosures) (see BPCB 5.9).
Companies should, as a rule, publicly report on corporate governance structures and anti-corruption systems, including their overall operations and performance. While many companies dedicate a section in their annual report to describe their corporate governance system, this should be complemented by information on what a business is doing to combat corruption. Coverage of these issues may be alternatively included in corporate citizenship or sustainability reports that companies publish.

1.6 European Commission: Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

TI considers that this depends on feasibility and the size of the institution. Specific board responsibilities should be designated to oversee corporate governance as well as ethical and integrity issues. Functions for policy formulation and oversight in the areas of corporate governance and company ethics should be clearly assigned to certain board member(s). Where feasible, depending on the size of the financial institution and the size of the board, the nature of the business areas of the financial institution and its risk profile, the establishment of a risk committee at board level should be strongly considered - this would create a direct link between risk management and the general board and ensure that risk management is held in higher importance. While a risk committee should discuss and prepare any decision of the board on risk issues, the overall accountability for risk management policy should remain with the board in its entirety.

1.8 European Commission: Should the chairman of the risk committee report to the general meeting?

Yes. Senior management should periodically report the results of risk management reviews to the board, and the results of reviews should be disclosed to the general meeting. A successful risk management policy is infused into all workings of an institution. The board should also report at a minimum on annual basis, to their shareholders (and to the public) on the continuing measures they are adopting to strengthen both risk management at the executive level and board governance of all aspects of risk management. The general meeting would be the forum where the board would explain and defend before shareholders their risk management policy **(see TI G 20 Recommendation 48)**

1.9 European Commission: What should be the role of the board of directors in a financial institution's risk profile and strategy?

The board, having sufficient background and ongoing training in risk management, are ultimately responsible for a company's overall exposure to risk. Therefore the board of directors or equivalent body, Chief Executive Officer and senior management should demonstrate visible and active commitment to the implementation of the enterprise's risk management programme.
The board should be kept informed of the institution's risk profile and strategy. Several members of the board should actively engage in risk management, either through participation on a board-level risk committee or through direct and regular liaison with risk management personnel. Senior management of the enterprise should monitor risk management and periodically review the programme's suitability, adequacy and effectiveness, and implement improvements as appropriate. Monitoring can occur through a newly-implemented risk committee at board level, a direct line of communication with senior risk personnel, or regular submissions to the board of the company's financial and non-financial risk profile. The director of the risk programme and senior risk personnel should receive continuous and appropriate training (see BPCB).

1.10 European Commission: Should a risk control declaration be put in place and published?

Yes. Risk management is based on a board commitment to fundamental values of integrity, transparency and accountability. These values should form part of a board's declaration of their commitment to ethical business practices.
There should further be a specific board-level declaration on risk management policy, to the effect that*:* *"The Board of Directors assumes full responsibility for its risk management programme, along with associated penalties and legal action in the case of improper conduct and breach of regulation."*
Disclosure of risk management systems contributes to the transparent functioning of financial institutions and reduces legal and financial exposure to non-financial risks such as bribery - robust anti-corruption policy, for example, can be used as a legal defence against allegations of systemic corruption within an institution.

1.12 European Commission: Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

TI recommends that mandatory reporting disclosure should include non-financial risk such as environmental and integrity standards, including anti-bribery programmes (integrated reporting). The board or equivalent body should make an independent assessment of the adequacy of risk management and disclose its findings in the institution's Annual Report to shareholders (see BPCP 5.8).

2. European Commission: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

TI seeks to expand the scope and importance of risk management so that it may encompass all aspects of non-financial risk that threaten the longevity of the institution and contribute towards systemic risk. This approach would be based on a comprehensive consideration of firm-wide risk exposure, a sharing culture of quantitative and qualitative information, on both financial and non-financial data, as well as an effective dialogue on risk management led by the board. Above all, the company should be transparent about its risk management and consult periodically with stakeholders on the process, identified risks and actions being taken to mitigate risks.

Prior to the crisis, attention was focused on internal controls related to financial risk - in the form of a 'ticking list' - rather than on the broader and more flexible context of the TI approach to risk management. Placing a greater primacy on the qualitative evaluations of the risk department would have prevented bankers from trading in complex, poorly understood and excessively risky financial products, often against the views of the Chief Risk Officer [CRO].

Broadly speaking, risk management should permeate all levels of a company. It encompasses many non-financial areas resulting from internal actions or failures of the organisation, particularly people, processes and systems. A successful risk management culture would include informal discussion of what is wrong or what could go wrong in all levels, an empowerment and upgrading of risk officers, a hard-headed allocation of capital towards risk management, transparent channels of communication and a clear set of board guidelines on risk management.

An essential problem to tackle is how excessive risk can be rewarded - currently employees have far more attractive incentives to disregard risk analysis and forge ahead with ever-riskier deals, safe in the knowledge that they will not face individual reprimand. Reducing incentives for high-risk transactions, promoting responsible employee performance, and raising the profile of risk-related personnel are fundamental to sustainable risk management.

The risk management that corporate governance systems strive to achieve must equally and accurately assess corruption hazards if the framework is to function. For example, more appropriate and effective whistle blowing procedures by companies (an anti-corruption tool) could have ensured that insiders who recognised the risks and abuses could have had a channel to voice them.

As a rule, anti-bribery policy should be contained within risk management to demonstrate a company's commitment to ethical business practice. Reporting on anti-bribery policy is an effective method to mitigate risk of legal action in the event of corruption and is also good for reputation, but most importantly, commitments against bribery frequently correspond to and promote ethical business principles more widely, and would create the type of safeguards and due diligence procedures that strongly support risk management.

A bribery report should be considered for submission to responsible management and board committees such as the governance committee or, if they exist, the risk management or corporate responsibility committees and ultimately to the board of directors or owner, to ensure paramount accountability. Financial Institutions should also consider disclosing their bribery policies, management systems and successes as part of their corporate social responsibility reports.

2.1 European Commission: How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

The Chief Risk Officer [CRO] must be able to report directly to the board. Making the CRO the level of Executive Director means that any outstanding risk issues can be raised immediately with the board. This initiative could be taken alone or with the establishment of a risk committee at board level, mentioned above. Regardless, it is of primary importance to ensure that the CRO reports directly to the board.

Firms should also set up a framework to protect the risk manager from any kind of pressure. In this sense, only the board would be able to overturn the CRO's decision, and only on a reasoned and disclosed basis. The CRO and his team should not be held solely responsible as a result of crisis - this reduces the attractiveness of the risk profession. Risk management requires a holistic approach at all levels.

The institution should consider developing career programs to attract the most talented staff to work for the risk department. Programmes of mentoring with risks managers could be put into place to encourage a strong risk culture as well as future moves to the risk department. High remunerations, glamour and excellent promotion prospects - in line with trading staff and similar financial operators - would encourage

young, talented professionals to choose the risk department rather the trading floor. Senior traders should be promoted to risk positions and firms to make clear that such moves are a potential stepping stone towards top management - effective risk management should represent a cornerstone of managerial principles.
Finally, the risk department's budget should be considered as of high priority. Training staff, upgrading the IT, attracting the most talented professionals and developing the risk culture should be the key budget considerations (see BCPB).

2.2 European Commission: How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

The institution should establish effective internal and external communication of risk management policies, including management systems employed to ensure adequate implementation.
The board of directors should ensure that it is informed of all internal and external matters material to the effective development and implementation of the risk management programme and, in particular, emerging best practices including engagement with all relevant interested parties.
There should be clear lines of communication and accountability between risk management and the board, either through a board-level risk committee, senior board personnel engaged with risk management, a periodic review of a company's risk profile or an approval procedure for all risk management activity. All of the above would contribute towards a stable risk management system.
The institution should subject the internal control systems, in particular the accounting and record keeping practices, to regular review and audit to provide assurance on their design, implementation and effectiveness. An effective system of organisational and financial checks and balances, allayed to an effective communications procedure, would help to create an early-warning system against excessive risk (see BPCB).
Importantly, there should be clear procedures of internal dispute settlement regarding risk-related decisions. Employees alerting the management of abuses should be protected from victimisation and retaliation. Case after case of corporate whistle blowing has shown that the majority of employees who report claims of corruption and misconduct are victimised and often forced to leave the company. To create a safe haven, TI calls for confidential hot lines and a supportive corporate culture.
Financial institutions should report, at a minimum on an annual basis, to their shareholders (and to the public) on the continuing measures they are adopting to strengthen both risk management at the executive level and board governance of all aspects of risk management. If the board disregard the opinion of the risk department in any important decision, they should have to explain the reasons before the general meeting (see **FSB Principles**). As part of an integrated report, the board should report publicly on the number of matters reported to the board by the risk management function alongside the number of times risk management recommendations were rejected.

2.3 European Commission: Should the chief risk officer (CRO) be able to report directly to the board of directors, including the risk committee?

Yes. Senior management should periodically report the results of risk management reviews to the board or equivalent body – there should be a direct relationship between personnel in charge of risk management and Board. If the CRO cannot report to the board by way of a risk committee, it is essential that the CRO has direct access to the board so that pressing matters can be raised without delay.

2.5 European Commission: Should executives be required to approve a report on the adequacy of internal control systems?

Yes. The board should sign off on regular reports and risk management strategies to assure full accountability. The board is ultimately accountable for risk management.

3. European Commission: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

3.3 European Commission: Should external auditors control be extended to risk-related financial information?

Yes. External assurance processes should be used to independently verify financial and non-financial data. External assurance is now almost universally mandated by law for company financial reporting. Consideration should also be given to requiring assurance work in other areas such as environmental and integrity standards, including anti-bribery programmes. A disclosure of non-financial good governance data relating to corruption would not be damaging to an institution's ability to remain competitive.

5. European Commission: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice? This means that the EU could initiate stakeholder discussions.

Strengthening shareholder democracy is helping to create an accountability mechanism to combat corrupt practices on the part of a company's board. The primacy of shareholder rights — such as for share buy-backs, dividend payments and running shareholder meetings — is a shift supported by companies and new national legislation, for example in France, Germany and Italy.
However, shareholder participation in corporate governance should be streamlined through transparent procedures. Formalising dialogues is a way of improving shareholder rights and, further, involving other interested stakeholders. These measures are particularly essential to provide for management's accountability on important business decisions that directly impact stakeholders and corruption risks.
Shareholder and stakeholder rights should include holding boards, owners and senior management accountable for their actions and respecting the rights of owners. The rights of minority shareholders must also be safeguarded to ensure their voice. Strengthened rights help to counter decisions that could provide a veil for boards to hide their corrupt actions or mask abuses.
TI advocates the protection of owners' rights and facilitation of their participation in company meetings including voting on changes to the company's structure (i.e. 'articles of incorporation') and key governance decisions (i.e. board membership and the remuneration of its members).

6. European Commission: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

6.1 European Commission: Is it necessary to increase the accountability of members of the board of directors? To whom? Can only be shareholders?

Yes. The board should be more accountable to shareholders, deposit-holders and other stakeholders for the actions of the institution. Improving board-level accountability ensures a primacy is placed on sustainable, long-term performance that benefits all stakeholders rather than short-term business decisions to the benefit of a few. It has been argued above that the risk committee should discuss and prepare any decision of the board on risk issues but the overall responsibility with regard to risk should remain with the board in its entirety.

6.2 European Commission: Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

Yes. The trend towards greater board accountability can be seen in regulation on corruption - the 2010 UK Bribery Act, for example, makes directors ultimately accountable in the instance that a company is found to be engaged in systemic bribery or fraud. Greater personal liability encourages directors to actively promote good governance systems.

7.1 European Commission: What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

Board Remuneration should be linked to long-term performance through deferred payment – this cools the appetite for short term, high-risk strategies and instead makes stable performance and long-term viability of the institution of paramount importance.
Board and senior executive remuneration and benefits packages should be made public, tied to sustainable performance and determined by independent, non-executive directors. TI supports governments and institutional investors in their call for shareholder approval of individual board and senior executive remuneration packages (including on types of long-term incentives, deferred stock options and pensions).

TI recommends further measures:

The focus of EU work should be to promote the integrity and accountability of financial institutions, and further the transparency of communication of general risk management policies (as opposed to firm-specific risk paradigms). EU efforts should encourage the disclosure of anti-corruption and fraud management systems, either as part of a financial institution's corporate social responsibility report or as a separate report on anti-corruption standards.

In addition, the EU can explore other areas that would significantly contribute to a culture of good governance. They should:

- Implement a single, easily understood set of global accounting standards in financial services firms.
- Establish comprehensive cross-border regulations that mandate stronger corporate governance in financial services firms, with particular reference to all aspects of risk management, greater accountability of boards of directors, and the disclosure of financial products offered by firms to their clients.
- Ensure regular reporting by supervisory authorities on the condition of institutions that pose systemic risks because of their size or leverage.
- Ensure regular and comprehensive reporting to the public by the multilateral institutions with lead responsibilities for financial reform and regulation – the Financial Stability Board (FSB), the Basel

Committee on Banking Supervision, the International Monetary Fund – on progress made by G20 countries on reforms as well as on further actions needed.
- Implement and enforce laws criminalising foreign bribery and prohibiting off-book accounts in accordance with the OECD *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* - G20 members who are party to the Convention should participate in its peer review process.
- Implement measures requiring reports on cross-border substantial financial transfers (see UNCAC Art. 14.2)
- Ensure that bank secrecy is overcome in investigations of offences covered by the United Nations convention against corruption (see UNCAC Art. 40)

About Transparency International

Transparency International (TI) is the global civil society organisation (non-governmental organisation) leading the fight against corruption. Through more than 95 chapters worldwide (i.e. in almost every EU member state and accession candidate and potential candidate country) and an international secretariat in Berlin, Germany, TI raises awareness of the damaging effects of corruption and works with partners in government, business and civil society to develop and implement effective measures to tackle it.

Jana Mittermaier
Head of Office

Des Carney
EU Policy Officer

David Fernandez-Valdes
Expert Advisor on Financial Service Reform

Transparency International
Liaison Office to the EU
Rue Breydel 40, 1040 Brussels, Belgium
Email: brussels@transparency.org
Twitter: http://twitter.com/ti_eu
Blog: http://europeblog.transparency.org
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