Corporate Governance Assessment Progression Matrix for Financial Institutions

Instruction Sheet

International Finance Corporation
WORLD BANK GROUP
Creating Markets, Creating Opportunities

The Governance of Financial Institutions

Investments in financial institutions comprise the largest single sector for IFC's business. Moreover, financial institutions are often regulated entities and are subject to specific governance rules and regulatory oversight. Therefore, it is important that the special governance risks and complexities posed by financial institutions are analyzed by IFC. Commercial banks and other deposit-taking financial institutions pose the greatest risks: first, since banks take large amounts of risk-bearing obligations on their books, weak internal controls and accountability can cause urgent and rapid crises; second, the collapse of a bank will usually destroy value for its public depositors, not just shareholders, and may even require a costly bail-out by the fiscal authorities; and, third, there is the systemic risk that the collapse of a single bank can undermine the entire banking system. Because of these special governance risks, banks are usually required by law or regulation to have certain specific governance structures and reporting standards. Although commercial banks are the main focus of IFC's financial institutions paradigm, most of these governance issues also apply to all other types of financial institutions that IFC invests in, including *inter alia* housing finance institutions, microfinance institutions, non-bank financial institutions and insurance companies.[1]

Financial institutions as intermediaries also have a keen interest in corporate governance practices of their borrowers and investees as a way to manage their (credit) risk. As such, risk governance and risk management policies and practices of financial institutions deserve enhanced attention. Furthermore, although financial institutions themselves have a low Environmental and Social (E&S) footprint, their clients and customers may expose these financial institutions to E&S scrutiny from the relevant stakeholders; therefore, having proper policies and procedures to deal with E&S risks and being responsive to stakeholder concerns may have a significant impact on financial institution's performance and reputation. Consequently, the CG Methodology tools have been enhanced to include relevant elements of governance of E&S.

Using the CG Tools

Eight key corporate governance (CG) tools are used for analyzing the governance of potential IFC investee companies. The Instruction Sheet, Financial Institution Progression Matrix, The Document and Information Request Lists, and the Sample CG Improvement Programs have been adapted to the specifics of Financial Institutions. [Note that, depending on the client and project characteristics, The Document and Information Request Lists can be either the Corporate Governance Review (CGR) Report Generator or the Corporate Governance Assessment (CGA) Tools.] The Model Independent Director Definition, the Supervision Checklist, the Supervision Checklist, Sample CG Improvement Programs or Sample Decision Book Section, and the explanatory note "Why Corporate Governance?" are applicable across all six paradigms, without any adaptations.

1) Instruction Sheet—Financial Institutions. The purpose of this Instruction Sheet is to describe each of the key CG tools, how they should be used, and who should be interviewed in the course of either a Corporate Governance Assessment or a Corporate Governance Review. (A full description of the step-by-step process for analyzing the governance of companies is provided in the section of the website, "Applying the IFC Methodology.")

2) Why Corporate Governance? This note explains IFC's approach as value-added for clients. *This explanatory note should be given to the client at the earliest opportunity in the pre-appraisal.*

3) Progression Matrix— Financial Institutions. The Progression Matrix relates six areas of governance (Commitment to Good CG, the Board of Directors, Control Environment, Transparency and Disclosure, Shareholders Rights and Governance of Stakeholder Engagement to four levels of achievement. The matrix framework emphasizes the importance of ongoing improvements in the governance practices of clients, rather than trying to apply rigid and static minimum standards. In particular, the Progression Matrix allows clients to assess the governance of their own institution against a simple framework. *The Progression Matrix should be given to the client at the earliest opportunity in the pre-appraisal.*

[1] The financial institutions paradigm includes questions that are most applicable to financial institutions that are also publicly listed. Therefore, it is not necessary to also apply the listed company paradigm to listed financial institutions. For those financial institutions that are not listed, some of the questions on the Information Request List may not be applicable and can be edited out.

4) The Document and Information Request List—Financial Institutions. This list of questions and requests for documentation establishes the basis for the CGA of an IFC client. The Document and Information Request List is organized along the same lines as the six areas of governance in the Progression Matrix. *For a CGA, The Document and Information Request List should be circulated to the institution at least three weeks in advance of the onsite visit.* The institution should identify a single officer who will be charged with responding to The Document and Information Request List by providing brief written answers of one or two paragraphs to each of the questions and delivering these to IFC prior to the onsite CGA. For the CGR, the investment officer must collect the required information from the documents or from interviews during the appraisal. If the investment officer elects to send a specially prepared CGR information request ahead of the site visit, an amended "questions only" version of the Report Generator should be sent to the client. Discussions relevant to IFC's understanding of the governance of a institution will arise throughout the appraisal and diligence process. Therefore, IFC Investment staff are encouraged to edit the information requests (CGA or CGR) as necessary before sending them to the client, to avoid duplication.

5) Corporate Governance Review Report Generator—Financial Institutions. This document is intended for use by Investment Officers (and CG Officers, in the case of detailed reviews) in conducting a Corporate Governance Review (CGR); preparing the corporate governance section of an Investment Review Memorandum; responding to questions from Director at the Investment Review Meeting; and in presenting any major issues to the IFC Board. The CGR Report Generator uses negative assertions on each area of risk, and then using questions to frame the risk issue and identify and assess relevant institutional practices and procedures, helps Investment Officers to determine the level to which the financial institution mitigates the risk. The Investment Officer is required to collect information about the institution and report in the Decision Book CG section which features are displayed by the client and which are not. The CGR Report Generator aids Investment Officers in preparing this CG section as it indicates the data that must be collected from the client and provides guidance on how to collect this by interviewing individuals at or contracted by the financial institution, or by reviewing a specific legal document.

6) Model Independent Director Definition. Perhaps the most common governance recommendation is to increase the board's independence from both the management and the controlling shareholders. However, to achieve genuine board independence, it is crucial to carefully define what it means for directors to be "independent." This Model Independent Director Definition is often used during discussions with the client to clarify the assessment of the current board and its future needs.

7) Sample CG Improvement Programs or Sample Decision Book Section (for CGRs)—Financial Institutions. Sometimes, a CGA results in the need for the client to develop and implement a Corporate Governance Improvement Program (CGIP). The CGIP should always be tailored to the circumstances and priorities of the institution. However, sample CGIPs give a good idea of what has been negotiated with clients in the past; therefore, they can be used as a reference point in the drafting process. The CGR always generates a section for the Decision Book, and sometimes this will include recommendations for improvements. This Sample CGR Decision Book Section provides a useful reference point for the investment officer's use.

8) Supervision Checklist. The Supervision Checklist provides a list of key issues that Investment staff should consider while supervising IFC investee companies and, in particular, those companies undertaking CGIPs.

Corporate Governance Interviewees

To carry out a thorough a corporate governance analysis (CGA or CGR), IFC staff need to have direct discussions with people who play a variety of governance roles in financial institution. This can be discussed. The precise interviewees will depend on each client and can be discussed with a CG Specialist in advance, if needed. This list might include the following (not necessarily all of below):

1. Representatives of controlling shareholders
2. Representatives of other holders of significant blocks of shares
3. Chair and members of the board of directors, including any "independent" board members, outside or non-family members of the board of directors and the chairs of the audit and other special committees of the board (and where applicable, members of the inspection committee: the fiscal board, *commisaire*, audit commission, *comisario*, or *revisor fiscal*)
4. Chief executive officer
5. Chief financial officer (or senior accounting officer)
6. General counsel (or senior lawyer)
7. Corporate secretary
8. Chief of internal audit and internal controls
9. Chief compliance officer
10. Chief risk officer [actuary, for insurance companies]
11. Chief of investor relations
12. Independent external auditors
13. Sustainability officer, or person in charge of External Communication Mechanism

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April 2019

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