GUIDANCE FOR SUPERVISORY BOARD MEMBERS OF BANKS

IFC Ukraine Banking Corporate Governance Project

September 2006

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TRIBUTE TO JONATHAN CHARKHAM

The inspiration for this guide was drawn from the *Focus* publication written for the Global Corporate Governance Forum, Washington DC, USA, by Jonathan Charkham CBE entitled *Guidance for the Directors of Banks.*

Sadly, at the time of composing this *Guidance for Supervisory Board Members of Banks*, Jonathan Charkham, who was providing advice on the guide, passed away.

Jonathan Charkham was internationally recognized as one of the founders of modern corporate governance and has played a significant role globally in many important corporate governance initiatives. In particular, he was one of the architects of the Global Corporate Governance Forum, which has collaborated with the IFC Ukraine Banking Corporate Governance Project in the production of this guide.

It is with deep gratitude and appreciation that IFC and the Forum obtained the benefit of Mr. Charkham's wisdom, extraordinary knowledge and guidance in its global mandate to assist with corporate governance reform throughout the world.

INTRODUCTION

This manual, for present and prospective Supervisory Board (SB) members of 'non-complex' banks, is intended to provide a guide to international best practice. It is designed to help Supervisory Boards in a practical way attain and maintain a high standard of internal governance.

This manual supplements a country's laws, rules and other local guidance. Together their aim is to set banks on the path towards enduring prosperity. This is a matter of great importance to all stakeholders of banks, including depositors, employees, customers, shareholders, the supervising authority and any others.

Good governance is essential for long term survival and success, so SB members have a continuing obligation to ensure that not only do they themselves understand and practice it, but that managers in their organization are properly trained in its principles and practical application.

This manual provides an overview. SB members are advised to familiarize themselves with the scope of the relevant legislation as they may be personally liable for breaches of certain provisions. The intention of this manual is to give SB members a fundamental understanding of their tasks.

The good governance of any commercial enterprise depends greatly on the skills, experience and knowledge of its SB members. Banks and other financial institutions require in addition that SB members keep abreast of relevant systemic, regulatory, technical and financial (including accounting) developments. It is therefore essential that individual SB members see this as a personal responsibility, and that the SB ensures they receive the advice and training they need.

This guide is sanctioned by the Global Corporate Governance Forum. Co-founded by the World Bank and the Organisation for Economic Co-operation and Development (OECD), the Forum is an advocate, a supporter and a disseminator of high standards and practices of corporate governance worldwide, especially in developing and transition economies. The Forum's donors include the International Finance Corporation and the governments of France, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the United States. The Forum (www.gcgf.org) brings together developed and developing countries.

NOTE: In order to understand all terms used in this guide it is recommended to read first the section GLOSSSARY OF KEY TERMS.

GLOSSARY OF KEY TERMS

AUDIT COMMITEE

The Audit Committee is a collegial organ of the SB that customarily oversees the financial reporting and internal control issues, supervises the internal audit function and relationships with external auditors (see section *Committees of the Supervisory Board* for details). Supervision of risk management issues is often undertaken by a specialized risk management committee as is mentioned below.

COMPLIANCE

Compliance refers to the necessity that a bank know, observe and comply with all laws, regulations, rules, standards and codes of conduct applicable to its activities.

Applicable laws, rules and standards generally cover matters such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice. They typically include specific areas such as the prevention of money laundering and terrorist financing, and may extend to tax laws that are relevant to the structuring of banking products or customer advice.

Compliance starts at the top. It will be most effective in a corporate culture that emphasises standards of honesty and integrity and in which the SB and senior management lead by example. It concerns everyone within the bank and should be viewed as an integral part of the bank's business activities. "C*ompliance risk*" is the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to practice good compliance.

CONFLICTS OF INTEREST

Conflict of interest is a conflict or a perceived conflict between the private interests and the official or professional responsibilities of a person in a position of authority or a conflict between executing inherently incompatible duties.

Conflicts of interest can arise in many ways and SB members should always be on their guard. When in doubt they MUST disclose the matter to colleagues. In many cases the circumstances will require their absence from deliberations in which they are 'conflicted'. One particular situation requires special attention: when they participate in the SBs of more than one company within the same banking group. They should be aware that their duty to more than one company might mean that they have different fiduciary responsibilities in their various roles, which can lead to a conflict of interest.

This means that there is no such thing as a 'representative' SB member, even when a particular group of shareholders have the right of appointment. Once appointed, an SB member is bound to act in the bank's interests, that is to say in the interest of <u>all</u> the shareholders and also the depositors. An SB member must not report to the shareholder he represents information that the SB deems confidential without its permission. SB members owe their duty to the bank_and are answerable to all shareholders for the way they discharge it (see Annex 1 for details).

CORPORATE GOVERNANCE

Corporate governance is the system by which banks are directed and controlled in pursuit of their aims and by which they relate to their sources of capital. The OECD defines it as a set of relationships between a company's management, its SB, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the bank are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the SB and the management to pursue objectives that are in the interests of the bank and its shareholders and should facilitate effective monitoring. As a result of good corporate governance the cost of capital is lower and bank resources are used more efficiently.

Effective governance is essential to maintaining confidence in a bank. Poor governance may contribute to loss in confidence, trigger a run or liquidity crises and ultimately even bank failure.

CORPORATE SECRETARY

Corporate Secretary is a position in a bank that is intended to ensure effective communication between the SB and Management Board (MB) as well as interaction with shareholders, other stakeholders and potential investors. Corporate Secretary responsibilities involve working closely with the Chairmen of the SB and MB preparing for board meetings, developing board agendas, director induction and orientation and should include maintaining internal documents, preparation of annual general meeting, support of work of SB and SB's committees and MB and interaction with shareholders.

FIDUCIARY PRINCIPLES (Duty of Loyalty; Duty of Care)

Duty of Loyalty is a fiduciary relationship that exists when a person is under a duty to act for the benefit of others. SB members have a duty to act for the benefit of the bank, shareholders, depositors and other stakeholders and to exercise their responsibilities in good faith when undertaking any corporate action. SB members must always act in the bank's interests even in the face of a competing obligation. It would be a breach of fiduciary duty to be disloyal to the bank (for instance by imparting its confidential or secret information) or to put one's personal interests (or those of family or friends) before the bank's interests. Consequently, an SB member may not benefit in any way, directly or indirectly, from his position on the SB except under specified circumstances which require full disclosure of the personal interests and the consent of the other members of the SB.

The Duty of Care requires a member to discharge his duties responsibly and effectively and to the best of his ability.

FIT AND PROPER

'Fit and Proper' is the set of criteria that should be met by all individual SB members. Fit and Proper criteria usually include ethical, professional experience, education and qualifications and financial soundness requirements. These criteria should be established by a bank and incorporated in its internal documents

The most important considerations will be the SB member's:

(1) honesty, integrity and reputation

- whether the person has been convicted of any criminal offence. Particular consideration will be given to offences of dishonesty or fraud.
- whether the person has been the subject of any adverse finding or any settlement in civil proceedings, particularly in connection with investment or other financial business, misconduct, or fraud.
- whether the person has contravened any of the requirements and standards of the regulatory system or the equivalent standards or requirements of other regulatory authorities, clearing houses and exchanges, professional bodies, or government bodies or agencies.
- whether the person has been a director, partner, or concerned in the management, of a business that has gone into insolvency, liquidation or administration.
- whether the person has been dismissed, disqualified, or asked to resign and resigned, from employment or from a position of trust, fiduciary appointment or similar.

(2) competence and capability

- whether the person has adequate education and qualification;
- whether the person has relevant experience and training.

(3) financial soundness

- whether the person has been the subject of any judgment over debt or award, in Ukraine or elsewhere, that remains outstanding or was not satisfied within a reasonable period.
- whether, in Ukraine or elsewhere, the person has filed for bankruptcy.

INDEPENDENCE

Independence means the SB member being independent of management and shareholders, objective in their appraisal of situations and unfettered in the opinions they express.

Independence means not yielding to threats or blandishment, but forming a view on the basis of the best available evidence and standing one's ground. Maintaining independence does not imply solitariness; concerns can be shared with independent colleagues. Independence means putting the bank's interests first.

Independence is an attitude of mind and an attribute of character. Apart from the circumstances listed above it may be compromised if SB members are under any financial or moral obligation that might curtail their freedom of action This may be the case if for instance they regard their appointment as being an act of patronage by the SB Chairman or the MB Chairman to whom they therefore owe personal loyalty.

It is often the case that an SB member may have or have had some connection with the bank, for example:

- Having had executive duties in the bank in recent years.
- Being a member of a firm that provides professional or other services or goods.
- Being connected to the management by blood.

Such people may have an important contribution to make to the SB and the bank but they cannot be said to be ‘Independent’. See Annex 2 for the criteria to be met by independent SB members.

INTERNAL AUDIT

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance.

Internal audit is part of the ongoing monitoring of the bank's system of internal controls and of its internal capital assessment procedure, because internal audit provides an independent assessment of the adequacy of, and compliance with, the bank’s established policies and procedures. As such, the internal audit function assists senior management and the board of directors in the efficient and effective discharge of their responsibilities as described above.

The scope of internal audit includes:

- the examination and evaluation of the adequacy and effectiveness of the internal control systems;
- the review of the application and effectiveness of risk management procedures and risk assessment methodologies;
- the review of the management and financial information systems, including the electronic information system and electronic banking services;
- the review of the accuracy and reliability of the accounting records and financial reports;
- the review of the means of safeguarding assets;
- the review of the bank’s system of assessing its capital in relation to its estimate of risk;
- the appraisal of the economy and efficiency of the operations;

- the testing of both transactions and the functioning of specific internal control procedures;
- the review of the systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the implementation of policies and procedures;
- the testing of the reliability and timeliness of the regulatory reporting; and the carrying-out of special investigations.

Internal audit function subordinates to the Audit Committee Chairman (see section *Committees of the Supervisory Board* for details).

LIQUIDITY

Liquidity is the means by which a bank ensures that it can always pay what it owes on time, which is vital to confidence in it and to survival. This is usually achieved by some combination of a well diversified asset base, holding readily marketable liquid assets, managing the maturity profile of assets and liabilities and borrowing/lending in the inter-bank market.

MANAGEMENT

Management in this Manual refers to the members of the MB and senior top management executives.

MANAGEMENT BOARD

The Management Board (MB) manages day-to-day activities of the bank and reports to the Supervisory Board (SB). The MB is responsible for achieving the goals and implementing the strategy and policy of the bank. In managing day-to-day operations, the MB makes decisions, executes contracts, and performs other acts aimed at achieving the bank's objectives. The MB must ensure the conformity of the bank's activity to the provisions of applicable legislation, resolutions of the Annual General Meeting of shareholders (AGM) and guidance of the SB.

RELATED PARTIES

The issue of related parties is important in many contexts, especially the concentration of risk. Per International Accounting Standard 24 a party is related to an entity (bank) if:

(a) directly, or indirectly through one or more intermediaries, the party:

- controls, is controlled by, or is under common control with the entity;
- has an interest in the entity giving a significant influence over it
- has joint control over the entity:

(b) the party is an associate of the entity;

(c) the party is a joint venture in which the entity is a partner;

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e).

A *related party transaction* is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

The danger is that improper preferential treatment may lead to a weakening of normal discipline in such matters as granting facilities, the terms and the subsequent monitoring of accounts and lending arrangements.

RISK MANAGEMENT

Risk management is the systematic process for identifying the risks the business faces, evaluating them according to the likelihood of their occurring and the damage that could ensue. Then deciding where to bear, avoid, control, or insure against them (or any combination of these) allocating responsibility for dealing with them, ensuring that the process actually works and for reporting material problems as quickly as possible to the right level.

STAKEHOLDERS

Stakeholders are parties who have an interest in the bank's prosperity but do not necessarily hold shares in it. Key financial stakeholders include therefore the bank's depositors, bondholders and providers of long term debt. However, customers, employees, suppliers, regulators and local communities are also stakeholders.

SUPERVISORY BOARD

The role of the Supervisory Board (SB) is to oversee the operation of the bank, control the activities of the Management Board and protect the interests of shareholders and key financial stakeholders. The SB reports to the AGM.

1 CORPORATE GOVERNANCE IN BANKS

Interest in the systematic way in which companies, including banks, are directed and controlled is relatively recent (arising over the previous 25 years). It was stimulated by concerns about fraud and the failure to correct evident managerial incompetence. Recently there has been strong interest in the role of Corporate Governance in facilitating investment and capital flows. These aspects are united in a single theme - if a bank wishes to attract investment it needs to show it is well and honestly run and that the information it distributes is comprehensive, reliable and accurate.

Experience has shown that good Corporate Governance requires sound structures and processes and that checks and balances are vital to ensure that power is not abused. This has implications for the role and composition of the Supervisory Board (SB), the creation of committees of the SB especially the Audit Committee, and the contribution that independent SB members can make to the decision making and monitoring process.

The emphasis of corporate governance developments has mainly been on control and monitoring and rightly so given the failures, frauds, and flows of misinformation that stimulated the reforms in the first place and are still a matter of concern today. The need for systems of control does not eliminate the need to put dynamic enterprise into new products, services and markets. Opportunity and risk are two sides of the same coin, but seeing opportunities requires flair, often a sort of creative genius, whilst systematically keeping risk under control is a relatively mundane but essential part of the process. Long term success depends on a balance between enterprise and control with high standards of both.

There is an identity of interest between SB members and banking supervisors in respect to corporate governance. Both want it to be as sound as possible and to be effective and efficient. It follows that SB members and supervisors should work closely together to achieve the best results.

The economic effects of good corporate governance benefit not only banks but also a wide range of stakeholders.

2 DIVISION OF GOVERNANCE FUNCTIONS IN BANKS

Achieving good Corporate Governance is in the hands of the three main stakeholders with the SB members in a pivotal position between shareholders and management:

- Shareholders provide the equity capital. Their powers are important but limited. They alone can appoint and dismiss SB members. Their agreement is required for certain types of transaction (specified either by legislation or the bank's by- laws), such as raising new capital or major acquisitions and disposals.

- SB members are entrusted by shareholders with the responsibility for the oversight of the business. They owe their loyalty to the bank and are accountable to the shareholders. This accountability implies transparency.

- MB members are appointed by and are answerable to the SB and have authority to run the business

This formal division of functions may be obscured if a major shareholder is simultaneously an SB member or a manager. This may produce an undesirable concentration of power. This arrangement can work well for a period of time but its weakness is that it may be difficult to deal with problems that arise when the leader falters or difficult to bring in new leadership. Corporate governance reforms have been designed to mitigate some of these effects because a dominant 'founding father' of a business can be hard to keep in check.

3 STRUCTURE AND COMPOSITION OF THE SUPERVISORY BOARD

The SB as well as the bank needs a leader and should have one of its members act as chairman. The SB Chairman is appointed by the AGM. It is his task to lead decisions on the composition of the SB itself. His responsibilities include the preparation for and conduct of SB meetings. He will sometimes be the public face of the bank in reporting on its progress. He can not have any other executive responsibilities in the bank.

Effective governance of a bank requires the SB to strike a balance at a high standard between driving the business forward and controlling it prudently. This balance will be assisted if a number of SB members are independent (as defined in Annex 2). In the last resort any SB should be able to challenge and control the MB Chairman and senior management.

Independent SB members must be people of character and relevant experience. They will often have a valuable constructive contribution to make both on and off the SB because of their knowledge and contacts.

Boards should be no larger than strictly necessary for the performance of their duties. The larger boards get, the more likely it will be in practice for serious decisions to be decided by an inner informal group of SB members which is not desirable.

An ideal SB will include members with a wide range of different backgrounds. Some perhaps with special financial, technical, or marketing skills, others with a breadth of other experience. International best practice requires a member of the audit committee of the SB to have a high degree of financial literacy. If the bank is involved in complex transactions, the minimum standard required should be that one member of the SB at least should be sufficiently knowledgeable to understand and question them. The general objective of having various skills is not to substitute their experience for expert advice, which the SB will need in particular situations, but to ensure that matters are appropriately considered and questioned.

Assessing how well the SB works together and the contribution, both on and off the SB, of its individual members is delicate and difficult but it needs to be done. One of the reasons for giving SB members a specified term of office, which should be the rule, is that reappointment provides an occasion for assessment. This does not preclude re-appointment but all SBs need periodically to refresh the membership and make changes.

4 DUTIES OF SUPERVISORY BOARD MEMBERS

GENERAL REMARKS

Banks are different from other enterprises in that if they fail this affects a far wider circle of people and moreover may undermine the financial system itself with dire effects for the country and beyond. This places special responsibility upon a bank's SB members. This responsibility remains with them even though they operate under the supervision of a regulatory authority whose task is to ensure their business is conducted in a way that is conducive to stability. It is of utmost importance that the SB members meet "Fit and Proper" criteria (for definition see the Glossary of Key Terms).

An SB member's first loyalty must be to the bank and in the execution of duties he must take care to put the interests of the institution above all others.

SB members must constantly keep in mind the capacity of those to whom they entrust authority and the framework for checking its sound, sensible and honest use. Unless they do this they cannot claim that they have discharged their responsibilities. Each SB member individually and the SB collectively should consider themselves responsible for the effective and efficient oversight of the MB of the bank.

SB members will need to meet as a board as often as the conduct of business requires but never less than quarterly. The SB should timetable all its regular meetings in advance for the coming year including a timetable for reporting from all the relevant committees and internal and external auditors. It is the Chairman's task, supported by the Corporate Secretary to ensure that an agenda with the relevant supporting papers is circulated to all members at least fourteen days in advance. The Chairman must ensure that the order of the agenda and the conduct of meetings do justice to the importance of the issues before the SB. Minutes of the meetings should be circulated in draft within seven days afterwards. They should record the principle arguments but not normally attribute them to individuals. Members who dissent or disagree from a decision the SB has reached may require the Corporate Secretary to record the fact in the minutes. Any individual SB Member may request a statement be included in the minutes to explain his vote and/or grounds for disagreement. The minutes should state the persons responsible for executing agreed decisions

PRINCIPAL DUTIES OF SB MEMBERS

The main SB members' duties are to:

- support and oversee the MB in its task of driving the bank forward and to that end to encourage innovation.

- consider with great care the bank's human, physical and financial resources and its strengths and weaknesses. To agree its mission, long-term strategy and its medium and short-term business plans, bearing in mind the external economic environment in which the bank will be operating.

- make sure that plans are communicated throughout the bank to those who will be affected by them.

- approve and monitor a clear framework of policies and objectives in all spheres within which management must operate.

LEADERSHIP

SB members have a duty to:

- set the tone for the behaviour of all the bank's employees by example and prescript per the bank's codes. Statements about the bank's corporate values and ethical policy should be short, simple and made available to everyone but it is the example of the SB members that constitutes the most persuasive statement about ethics.
- disclose any possible conflicts of interest in matters before the SB and abstain from participating in discussions and refrain from voting (which should be minuted) in such cases.
- encourage the confidence of all stakeholders in the integrity of information from the bank. SB members must recognize the dictates of commercial confidentiality, but never use this as an excuse for unnecessary opacity. They should consider transparency to be the norm. The burden of proof rests with those who would wish to limit it to show that commercial necessity has to be paramount.

MONITORING AND CONTROLLING

SB members have a duty to ensure that:

- there are sound systems for decision making and control and that the systems are effective by having them regularly tested and reported upon.
- there is an effective internal audit function with a direct reporting line to the SB Chairman (or Chairman of Audit Committee if established) and the right of access at all times to the Chairman of the Audit Committee.
- the SB receives periodical reports about the financial position of the bank and its performance in the form (including the degree of detail) and at intervals most appropriate to its business.
- they monitor progress towards the bank's objectives (this will often be set in the context of performance against budgets).
- managerial responsibility for each system is in sound hands and that managers know the risks they 'own'.
- the bank's operations comply with legislation. To receive and review reports from the auditors, management, the Audit Committee, the Compliance Officer and Corporate Secretary on material breaches of legislation and internal procedures and policies and ensure that management takes the necessary action.
- managers address all security related matters and receive expert advice on the design, planning, and implementation of security standards, procedures, and systems covering all aspects of physical and technical security aimed at

safeguarding the assets and operations of the bank. Breaches should be reported and serious incidents or shortcomings should be brought to the attention of the SB.

- written rules are promulgated to prevent fraud and to deal with it if it is suspected or discovered. Frauds and suspected frauds should be reported at once.

- they satisfy themselves that the bank's arrangements for detecting and reporting money laundering conform to legislation.

- they oversee and approve related party transactions to the extent that this responsibility does not pertain to the Shareholders Meeting. The SB should ensure that credit assessment and lending are always conducted on the 'arm's length' principle. Related party transactions should be disclosed in a meaningful way in the annual report prepared by the bank as per applicable International Financial Reporting Standards. The distortions caused by related party transactions extend far wider than credit risk and may damage the reputation of the bank. The SB needs to make sure that the bank is not injured.

- any operations abroad are well-considered, carefully monitored and controlled. SB members must bear in mind that operations overseas, especially in the main financial centers, are fiercely competitive and that this imposes exceptional strains on the bank's officials in the form of the quality of local staff they are able to recruit and the risks they are assuming in their efforts to build up the business.

To ensure adequate fulfilment of these duties it requires the bank to organise regular trainings in areas of monitoring and internal control for every SB member as well as establishing an effective Audit Committee (see section *Committees of the Supervisory Board* for details).

HUMAN RESOURCES

SB members have a duty to:

- appoint of competent MB members and when necessary propose the dismissal of inadequate ones. The role of the SB in the appointment or dismissal of the MB Chairman is in practice perhaps the single most important function of the SB.

- ensure that the MB establishes policies designed to maintain the quality of management by sound appointments. It is vital that at all levels management should know their staff and have ascertained that they are fit and proper for their work. Their competence and honesty should be above suspicion.

- make sure that programmes are established for training and retraining at all levels in the bank including SB members themselves. Newly appointed SB members should have an induction course on appointment to familiarize them with the bank's operations and functions of the SB and its committees.

- oversee adequate staffing of internal audit (which should report to the SB or Audit Committee, if established) with qualified personnel.

- ensure that the remuneration policy for SB and MB members is appropriate.

- protect members of the SB by insuring them against personal liability.

RISK MANAGEMENT

SB members have a duty to:

- oversee the risks management process in the bank. This is an overall responsibility of the SB and cannot be delegated to any SB committees. If the SB has created a committee to oversee the risk management process (Risk Committee or Audit Committee) this committee should report to the whole SB on all relevant matters and the SB is the final decision maker.
- ensure that adequate procedures for managing all risks are established by the MB. The SB should receive and review regular reports on compliance with risk management policies in the bank. The SB must recognise that some residual risks always remain which the MB must identify, mitigate or accept.
- monitor liquidity and the financial position regularly.
- monitor the adequacy of the bank's capital in the light of the types of business it proposes to conduct and the risk attaching to each.
- ensure effective policies are in place and are followed covering loan granting and monitoring.
- make sure that the MB has put in place the necessary insurance policies, using professional insurance advisers, and to receive and review regular reports on the insurance coverage and the reliability of the insurance companies for matters not involving negligence, malfeasance or neglect of their duties.

COMPLIANCE

The volume and complexity of legislation and regulation that now applies to banks are so great that no SB member could reasonably be expected to master all the details. Nevertheless all SB members should:

- know what the scope of the main laws and regulations is;
- ascertain where within the bank appropriate expertise lies;
- know how compliance with the law is assured; and
- receive reliable reports on compliance and any material failings.

If the bank is quoted on a stock exchange SB members should be aware of the obligations that flow there from in Stock Exchange Listing rules, Codes of Corporate Governance and so forth.

SOCIAL RESPONSIBILITY

There is a broad social responsibility dimension to the role of SB members in respect to stakeholders. The SB is accountable only to the shareholders but the interests of other stakeholders must be taken into full consideration. To neglect any of them is to invite problems and difficulties. A concern for ‘stakeholders’ is a part of what has come to be called “Corporate Social Responsibility”. SB members should ensure that the bank follows policies that are socially responsible in all relevant areas including care for the environment.

INFORMATION DISCLOSURE AND TRANSPARENCY

Responsibility for the disclosure of full and accurate information in the bank shall rest upon the SB acting as a guarantor of the existence and effectiveness of the system of information disclosure in the bank.

SB members should ensure that there is a communications strategy and procedures for disclosing information inside the bank and to the public. This should also include a description of the role of independent members in the disclosure process. The MB should be responsible for implementing the communication strategy and procedures.

The bank should appoint an individual with the task of organizing the process of information disclosure. The terms of reference of such an individual should include ensuring access to public information. It is recommended to assign these tasks to the Corporate Secretary of the bank.

The SB (with a proposal from an Audit Committee, if established) has the responsibility for vetting financial statements and discussing them with the auditors to ensure that any reports issued by the bank, including the financial statements, present a ‘true and fair’ view of its position and performance.

The following information about SB and its committees should be disclosed in the annual report and on the web-site:

- structure and composition
- professional background and experience of its members
- role and functions
- report of activity and participation in SB and its committees’ meetings
- remuneration policy and amounts.

5 COMMITTEES OF THE SUPERVISORY BOARD

GENERAL REMARKS

Boards establish committees to optimize the efficiency of the board by focusing attention and expertise on specific areas of its responsibility. The SB may delegate authority to its committees but remains ultimately responsible for the effective work of its committees and will:

- approve committee by-laws
- establish "Fit and Proper" requirements
- appoint the chairmen and members
- establish reporting procedures
- monitor the committees' effectiveness
- evaluate performance of its members
- establish adequate remuneration
- refresh membership as needed to maintain its skills and commitment

The most common SB committees in banks are:

- Audit
- Risk
- Corporate Governance & Nomination
- Remuneration

Composition

The committees should consist of at least 3 members with the quorum of two votes. The members will be appointed by the SB. For all committees (for Audit Committee see below) the maximum period for an initial appointment should be three years and it may be extended with the approval of the SB. The extension of term should not be automatic.

Meetings

Every SB committee should meet as often as needed but at least four times a year. For the regular meetings agenda and supporting information package should be distributed at least fourteen days in advance.

The minutes of the meetings should be kept by a committee secretary. Organisation of SB's and its committees' meetings, preparation and keeping minutes of meetings can be assigned to the Corporate Secretary or to a person vested with these duties. Minutes of committees' meetings should be circulated to all SB members within seven days afterwards and be placed on the agenda of the next SB meeting.

MB members, senior management as well as any employee of the bank may be invited to committees meetings as it may deem desirable or appropriate, subject to the maintenance of confidentiality where required. Other particular aspects of committees' meeting procedures are described below.

Other particular aspects of committees' composition are described below.

Special Comment

At the current stage of development of Ukrainian banking sector it is appropriate to establish a combined Audit & Risk Committee as well as single combined Corporate Governance, Nomination & Remuneration Committee.

AUDIT COMMITTEE

The key features of a good Audit Committee (AC) are its expertise and its independence. The Audit Committee plays a central role in internal control and financial reporting.

Functions

The key functions of the AC are:

- *Monitor integrity of financial and other public reporting*

  (a) To review financial reports before the SB as a whole considers them, focusing particularly on changes in accounting practices, significant adjustments resulting from the audit and compliance with financial reporting standards.

  (b) To ensure that financial reports present a true and fair picture of the bank's position and performance.

- *Ensure efficiency of internal controls and risk management procedures*

  (a) To appraise and re-enforce the control environment. As part of this, it will review the internal controls, risk management procedures, management reports and the information presented to regulatory agencies.

  (b) To ensure that the MB maintains a sound internal controls and financial reporting systems.

- *Supervise the work of internal auditors and oversee relationship with external auditors*

  (a) To ensure independence, objectivity and qualifications of internal and external auditors.

  (b) To make recommendations to the SB on appointing or removing the external auditors.

  (c) To review periodically the remuneration and performance of the external auditors and ensure a periodic change of senior audit partner.

(d) To supervise the internal audit function.

(e) To receive and review internal audit reports and draw attention of the MB and SB to any material matters.

(f) To engage external advice as required.

- *Ensure bank's compliance with regulations and internal procedures*

(a) To review the external auditor's letter to bank's management (containing recommendations on internal control issues) and consider the adequacy of the MB's response.

(b) To ensure compliance with regulatory requirements and internal procedures through reviewing reports from the MB and internal and external auditors. Due attention must be paid to breaches of regulations, related party transactions and litigations.

Composition

The AC of 3 to 5 members will be appointed by the SB and should be chaired by an independent SB member. The period for an initial appointment should be no less than three years and it may be extended with the approval of the SB.

Besides the personal qualities of judgment and character, members should be chosen for their experience and acumen and their capacity to handle the reports they will receive about risk and the operation of the bank's various systems. At least one AC member should have extensive financial or accounting expertise.

The AC Chairman

The SB appoints the AC Chairman who sets the Committee's style, tone and agenda therefore the AC's effectiveness depends heavily on him. The AC Chairman must possess strength of character and be independent, as defined in the Glossary of Key Terms and Annex 3. The SB Chairman cannot be AC Chairman in order to avoid potential conflicts of interest.

Meetings

The AC apart from its regular meetings should also have meetings with external and internal auditors as necessary. Ideally the decisions the AC reaches will be unanimous. If there is a vote and it is tied, the Chairman's view prevails.

- The AC should have the right to:

  (a) conduct meetings without management present

  (b) hold meetings at least twice a year with external auditors without management participation

  (c) direct access, without management presence, to the head of internal audit

  (d) access to any employee

(e) conduct internal investigations as needed

(f) obtain professional advice at the bank's expense.

Relationships with the Regulators

The AC should see itself as an ally of the regulators. They share a concern for sound controls and accurate information. It follows that there should be close co-operation and openness.

RISK COMMITTEE

Functions

Though overall responsibility for oversight of risk management rests on the SB, it may consider establishing a Risk Committee (RC) that can take over the following functions:

- steer MB towards the right risk choices
- take a portfolio view of bank risks
- understand and influence management risk appetite
- systematically monitor the risk situation.

Further functions of the RC are to:

- review and approve policies that clearly quantify acceptable risk and that specify the quantity and quality of capital required for the safe operation of the bank
- design and recommend to the SB for approval structures that include clear delegation of authority and responsibility at each level
- ensure that MB and top senior management effectively takes the steps necessary to identify, measure, monitor, and control all the bank's financial and operational risks.
- periodically review procedures and controls to ensure that they remain appropriate, and make periodic assessment of the long-term capital adequacy program.
- obtain explanations where positions exceed limits, including reviews of credits granted to SB and MB members and other related parties, significant credit exposures and adequacy of provisions.
- be apprised specifically of the major risks (or major risk combinations) that could significantly alter business perspectives
- evaluate the way in which management has embedded risk management within the bank, asking organizational questions, such as "Do we need a

chief risk officer?" and technical questions, such as "Which tools are being used?".

Composition

At least one member of Committee should be independent. The Chairman of the SB can not be the Chairman of the RC. The RC should be chaired by independent member.

CORPORATE GOVERNANCE & NOMINATION COMMITTEE

The main objective of the Corporate Governance & Nomination Committee (CGNC) is to assist the SB in fulfilling its corporate governance duties including reviewing corporate governance practices observed within the bank (including SB and MB practice and performance) and assuring adequate selection of SB and MB members.

Functions

The functions of the CGNC are to:

- develop and recommend to the SB a set of corporate governance principles applicable to the bank, to review those principles at least once a year and to monitor and evaluate disclosure of such principles;
- assess the SB's relationship with the MB and senior management and recommend, where necessary, limits on management's authority to act without explicit SB approval;
- monitor business practices in relation to preserving the reputation of the bank
- review the SB agenda, to recommend topics of interest or importance for discussions and/or action by the SB and to address information requirements of the SB members
- elaborate "Fit and Proper" requirements and ensure that SB members meet these criteria.
- ensure a thorough and objective selection of candidates for the SB and MB
- establish and review induction and ongoing training for newly appointed SB and MB members

REMUNERATION COMMITTEE

Adequate remuneration of SB and MB members is a key element of the efficient performance of the bank. Therefore it is essential that there should be openness about the MB and SB members' selection processes. There is a potential conflict of interest for SB members who decide their own remuneration. It may help resolve this if the SB appoints an independent SB member to chair this committee.

Functions

The key Remuneration Committee (RC) functions are to:

- review remuneration of SB and MB members, including their Chairmen and ensuring that remuneration is consistent with the bank's culture, objectives, strategy and control environment
- liaise with the Audit Committee in relation to remuneration related disclosures in the financial statements and annual report
- establish and review succession plans for the Chairmen of the MB and SB
- oversee staff policies for compensation and benefits to assure they correspond to the strategy and goals of the bank
- review MB's plans for maintaining, developing and finding talented officers and staff to assure future success of the bank

Composition

At least one member of Committee should be independent. The Chairman of the SB can not be the Chairman of the RC. The RC should be chaired by an independent member.

ANNEX 1 - CONFLICTS OF INTEREST

A conflict of interest exists when an individual's personal interests interfere or appear to interfere in any way with the individual's duties to the bank or the interests of the bank. A conflict can arise when an employee, officer or board member takes action or has interests that may make it difficult to perform responsibilities and duties for the bank objectively and effectively, or may improperly influence individual judgment when acting on behalf of the bank. Conflict situations may also arise when an employee, officer or board member, or members of his or her family, receives an improper personal benefit as a result of his or her position with the bank.

All SB members, employees of the bank, or persons who have the power to direct the bank's management or policies or who otherwise owe a fiduciary duty to the Bank, have an affirmative duty to promote and advance the interests of the bank, and shall not advance their own personal or business interests, or those of others with whom such persons have a personal or business relationship, at the expense of the bank or in conflict with any obligation owed to the bank. These persons have a fundamental duty to avoid actual, potential or perceived conflicts of interest with the bank.

The following situations can lead to potential or actual conflicts of interest, when a person:

- has any major ownership interest in any counterparty of the bank
- has any consulting or employment relationship with any counterparty or competitor
- conducts any outside business activity that detracts from an individual's ability to devote appropriate time and attention to his or her responsibilities with the bank
- receives non-nominal gifts or excessive entertainment from any company with which the bank has current or prospective business dealings
- is in the position of supervising, reviewing or having any influence on the job, evaluation, pay or benefit of any immediate family member of any customer, supplier or competitor
- holds a post of SB member at the bank and being employed as a key executive of another company in which an SB member of that company is an executive of the bank
- is a SB member in other companies which interest may interfere with the interests of the bank;

The following examples of conflicts can be provided, but are not intended to describe all situations that might appear:

- a person who owes a fiduciary duty to a bank receives money or other benefits from a third party in return for a bank granting a loan to or purchasing property from the third party
- a third party makes a payment or provides employment to a spouse, child, parent, sibling or business partner of an employee or affiliated person of a bank to influence the bank's decision on a loan or other benefit to the third party
- an employee or other person who owes a fiduciary duty to a bank advocates a transaction between a bank and a company in which such person owns stock or serves as an officer or director, at the expense of a bank
- employees may refer potential borrowers to a bank but must not imply to either bank staff or the borrower that preferential treatment will be given.

The following procedure should be followed at SB meetings in cases of potential or actual conflict of interest:

- SB members having a conflict of interest (hereafter referred to as "conflicted members") are required to disclose the full nature and extent of their interests to the SB. The disclosure of the conflicted member should be made at or before the SB meeting when any issue relating to the conflict is to be discussed. Members must identify those situations where they might have a conflict of interest or where a reasonable person might conclude they have a conflict of interest in the activity in which they are participating or about to participate. The disclosure can be made orally or in writing and should be recorded in the minutes.
- Conflicted members are entitled to receive notice of any SB meeting at which the matter which is the subject of the conflict (hereafter referred to as the "conflicted matter") is to be considered and have the right to attend the meeting. Conflicted members shall not be included in the quorum for any resolution concerning the conflicted matter.
- Conflicted members should not participate in discussions on the conflicted matter and should volunteer to or may be asked to withdraw from the meeting for the duration of any such discussions to facilitate full and frank consideration by the rest of the board of the conflicted matter
- A conflicted member shall not vote on any resolution concerning conflicted matters.
- SB members having a continuing material conflict of interest should consider resigning or at least seek independent professional advice on the merit of continuing to serve on the SB.

ANNEX 2 - INDEPENDENT SB MEMBER

According to Ukrainian Corporate Governance Principles approved by the Securities and Stock Market State Commission in December 2003 to secure independence of the Supervisory Board, due care should be taken to ensure that at least one quarter of its members are independent. A Supervisory Board member is independent if he/she has no serious business, family, or other connections with the bank, members of the executive body, or a large shareholder of the bank, and is not a representative of the state.

A Supervisory Board member can not be considered independent if he/she:

- serves or has served for the last three years as the chair or a member of the bank's executive body or as an officer of a governing body of a subsidiary of the company;
- is a related party in relation to the bank or to persons who are parties to any liabilities of the bank for a total annual amount in excess of 5% of the book value of the bank's assets at the start of the financial year;
- obtains any income from the bank, other than compensation for performing the mandate of a Supervisory Board member and income generated by his or her ownership of the bank's shares;
- owns more than 5% of the bank's shares (individually or jointly with related parties);
- is a representative of the state.

The Supervisory Board should annually check whether Supervisory Board members meet the independence requirements established by the bank. Information on the number of independent members should be disclosed in the annual report.

The bank may set additional and/or more stringent independence requirements for Supervisory Board members. As a best practice example of the more stringent criteria for independent SB members below are presented the respective criteria used by IFC.

Independent SB member means an SB member as a person who:

- has not been employed by the bank or its related parties in the past five years;
- is not, and is not affiliated with a company that is an advisor or consultant to the bank or its related parties;
- is not affiliated with a significant counterparty of the bank or its related parties;
- has no personal service contracts with the bank or its related parties, or its senior management;
- is not affiliated with a non-profit organization that receives significant funding from the bank or its related parties;

- is not employed as an executive of another company where any of the bank's executives serve on the SB of that company;
- is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the bank or its related parties as an executive officer;
- is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the bank or its related parties; or
- is not a controlling person of the bank (or member of a group of individuals and/or entities that collectively exercise effective control over the bank) or such person’s brother, sister, parent, grandparent, child, cousin, aunt, uncle, nephew or niece or a spouse, widow, in-law, heir, legatee and successor of any of the foregoing (or any trust or similar arrangement of which any such persons or a combination thereof are the sole beneficiaries) or the executor, administrator or personal representative of any Person described in this sub-paragraph who is deceased or legally incompetent, and for the purposes of this definition, a person shall be deemed to be "affiliated" with a party if such person (i) has a direct or indirect ownership interest in; or (ii) is employed by such party.

The International Finance Corporation (IFC), the private sector arm of the World Bank Group, is the largest multilateral provider of financing for private enterprise in developing countries. IFC finances private sector investments, mobilizes capital in international financial markets, facilitates trade, helps clients improve social and environmental sustainability, and provides technical assistance and advice to businesses and governments. From its founding in 1956 through FY06, IFC has committed more than $56 billion of its own funds for private sector investments in the developing world and mobilized an additional $25 billion in syndications for 3,531 companies in 140 developing countries. With the support of funding from donors, it has also provided more than $1 billion in technical assistance and advisory services. For more information, visit www.ifc.org

The Swiss State Secretariat for Economic Affairs (SECO) supports the Ukraine Banking Sector Corporate Governance Project and the Ukraine Corporate Development Project, implemented by IFC. The promotion of sound corporate governance practices is an important part of SECO's strategy to promote a better economic environment for private investors in transition countries. With this initiative SECO underlines the importance of private sector development for the process in the transition countries to develop a viable market economy.

The primary objective of the Economic Development Cooperation of SECO is the reduction of poverty in its partner countries by promoting sustainable growth and by supporting their integration into the global economy. In Eastern Europe and the CIS SECO holds an annual budget of nearly CHF 80 million and supports projects in 10 countries, mainly in the areas of infrastructure, private sector development and trade promotion.
www.seco-admin.ch