



IFC Corporate Governance
Knowledge Publication

FOCUS 13

Challenges in Group Governance: The Governance of Cross-Border Bank Subsidiaries

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Foreword by Eddy Wymeersch

Challenges in Group Governance:

The Governance of Cross-Border Bank Subsidiaries

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Foreword

This publication focuses on the governance of the subsidiaries of banking groups, with particular emphasis on cross-border bank subsidiaries. Thought on the issue originated during a series of high-level meetings organized by IFC on the governance of banks in Southeast Europe (SEE) in 2010 — a time when the effects of the 2007–2008 financial crisis still lingered, giving the meetings a sense of urgency. Participants reflected on the role that governance may have played in the crisis and what could be done to prevent a recurrence.

One of the important observations these participants made was that the crisis did not originate locally. Even if governance practices in SEE could stand to improve significantly, local banks were not the source of the problem. The crisis had been introduced by foreign banks through their local subsidiaries. The customary fear of contagion spreading from less-developed financial markets to more-developed markets had been turned on its head.

Understandably, the position of SEE countries was that foreign bank subsidiaries needed to be made safer. One of the ways of doing so was to impose stricter capital, liquidity, and risk-management standards, and in some cases ring-fencing. However, proposals also included changes to subsidiary governance. Generally, these proposals included making subsidiary boards more like the boards of standalone banks, with a greater localization of strategy and control within the subsidiary. Specific proposals included more mandatory committees, independent directors, and directors with more local expertise.

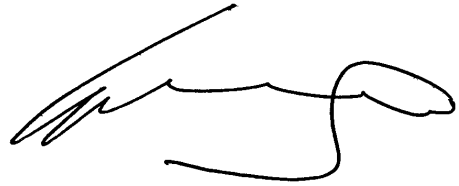
Thus began a discussion on governance practices that might help attenuate or even prevent future crises. Another high-level meeting and further discussions among international experts took place in 2014. This publication aims to organize, document, and clarify some of those discussions. To foster a better understanding of this issue, it looks at subsidiary governance practices through the eyes of parents, subsidiaries, and supervisors. The issues of governance of bank subsidiaries are global, and both the meeting and the publication seek to cover practices around the world. The objective is to offer some preliminary thoughts and to present balanced and reasoned options.

One of the key observations made in developing this publication was that many banks view governance of subsidiaries as a “tick the box” exercise with marginal value to their operation — particularly when regulatory requirements do not take into account business exigencies. On the other hand, banks take governance seriously and appreciate its value when rules are balanced, measured, and practical, helping them achieve results. Another observation is that many banks do not fully appreciate the role governance plays in controlling risk in increasingly complex international banking groups.

The governance of bank subsidiaries has received insufficient study, and empirical evidence is scant — though there is burgeoning interest among banks. Given the scarcity of information and lack of a clear consensus, this publication stops short of making detailed recommendations. It encourages supervisors to adapt their approaches to fit market realities and to be more aware of the incentives for good governance. It also emphasizes the importance of proportionate

and risk-driven approaches to supervision. At the same time, it encourages banks to look beyond the achievement of business goals and consider the issues of risk and stability that are ultimately a concern to us all.

The matter of bank subsidiary governance is a global issue with profound implications. There is surely more to be said on the topic. Our expectation is that this publication will move the discussion of what constitutes good subsidiary bank governance one, if only a small, step forward.

A handwritten signature in black ink, consisting of a series of loops and strokes, representing the name Eddy Wymeersch.

Eddy Wymeersch

Professor, Law Faculty, Ghent University
Former Financial Supervisor
Member, IFC Private Sector Advisory Group

Preface: How to Use this Publication

This publication lends itself to careful perusal as well as quick reference. An executive summary enumerates the main points, and callouts in the main text summarize the key messages of individual pages. The main body of the text provides an in-depth discussion and further detail, and text boxes, figures, and quotes add enriching perspectives. The two appendixes offer 1) Basel Committee guidance on the governance of bank subsidiaries and 2) a selection of recommendations from a past IFC publication on governance of banks in Southeastern Europe. Finally, the list of references consulted during preparation of this publication may be useful for pursuing a deeper understanding of the issues. It is important to note that this publication reflects the views of bankers, regulators, and others on a deeply complex and complicated issue and is *not* intended to be a comprehensive or even complete evaluation of the issues explored.

Acknowledgments

Philip Armstrong directed the project team responsible for the development of this publication. Ralitza Germanova ensured that the initial idea came to fruition; she guided the development of the concept, arranged meetings, collected and synthesized feedback, and organized the final production. In-depth comments came from (in alphabetical order) Laura Ard, Piotr Bednarski, Charles Canfield, Antonella Deo, Lucille D'Souza, Leo Goldschmidt, Anne Molyneux, Stilpon Nestor, and Patrick Zurstrassen. Special thanks to David R. Beatty C. M., O. B. E., who chaired group discussions in Vienna. Shannon Roe provided editing support.

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Please note that the comments made during preparatory meetings or in the quotes that appear in this publication represent personal opinions and not necessarily those of the institutions the commenters are affiliated with. The views presented in this publication are ultimately the sole responsibility of the author. The publication reflects the views of bankers, regulators, board directors, and international experts on a deeply complex and complicated subject and is not intended to be comprehensive or even a complete evaluation of the issues explored in this document.

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Executive Summary

Below are brief summaries of the key points covered in this publication. They are numbered for easy reference and categorized to match the content in the main body.

Background and the need for tailored governance approaches

1. *Fears of contagion:* The recent financial crisis upset the traditional view of contagion moving from countries with less-developed financial markets to those with more-developed financial markets. As a result of the 2007–2008 crisis, subsidiaries of large foreign parents from highly developed markets were increasingly viewed as potential threats to the stability of financial markets in smaller countries.
2. *Governance as a support to regulation:* Better governance practices are expected to support the implementation of the Basel accords and emerging national banking regulation. All major banking markets are working on regulation that has implications for parent and subsidiary governance.
3. *Tailored governance:* Subsidiary banks are a highly heterogeneous group. There is a trend toward bringing governance practices developed for standalone and listed banks down to the subsidiary bank level. However, different ownership structures, levels of board autonomy, business models, and governance structures all suggest that subsidiary governance needs to be tailored and proportional to the nature of the subsidiary.
4. *Further study required for subsidiary bank governance:* At present, only general principles for subsidiary bank governance can be identified. Despite the highly heterogeneous nature of subsidiary banks, we can identify some initial principles to guide subsidiary governance for parents, subsidiaries, and supervisors. More work is needed to better define good subsidiary governance practices.

Subsidiary governance from the perspective of the parent

5. *Tracking the governance practices of subsidiaries:* Parent banks are responsible for knowing the governance practices used across the group and for ensuring that appropriate governance mechanisms are in place. Best practice suggests that parent banks be capable of accurately tracking subsidiary governance.
6. *Subsidiary governance unit:* If the size and complexity of the bank warrant it, parent banks may find it useful to establish a dedicated subsidiary governance unit. Such specialized units are increasingly seen as the standard of good practice for large parents with a multinational reach.
7. *Uniform policies:* Parent banks need to develop uniform policies and guidance for subsidiary governance that are aligned with parent requirements. Groupwide governance policies are made more effective when supported by embedded procedures and complemented by training and a support network of competent governance professionals.

Governance from the perspective of the subsidiary

8. *The board's responsibility to the parent:* Typically, company law requires boards to act in the interest of the company and in some jurisdictions this extends to include shareholders (owners). Yet parent and subsidiary interests may conflict. A balance needs to be struck between some level of independence for subsidiaries and the needs of the group. Achieving the proper balance is a significant challenge.
9. *The board's obligation toward stakeholders:* Banking distinguishes itself from most other businesses in that it has a strong public-good dimension. The board's obligation toward stakeholders is to take into account the legitimate interests of stakeholders while pursuing the interests of the bank and ensuring compliance with prudential regulation that protects stakeholder interests, e.g. depositors, debt holders, etc.
10. *The board's role in strategy:* It is essential that the parent maintain control of the strategy of the group. The subsidiary board can provide input that helps ensure that the strategy developed at higher levels is sound and practicable at the subsidiary level.
11. *The board's role in internal control and risk management:* Risk analysis and control cannot rely solely on the home office and, to be most effective, should be informed by local circumstances and draw on local expertise. Subsidiary boards should examine whether they have in place adequate internal controls and consider whether they rely excessively on services provided by the group.
12. *Independence:* Boards have enormous expectations of independent directors. Fulfilling such expectations is difficult and may, in fact, be unrealistic. Some boards resort to box-ticking approaches to selecting independent board members, and some hire them purely as window dressing. To achieve the goals of independence and objective thinking, subsidiary banks may find the careful selection of directors from among group executives just as effective as insisting on formal independence.
13. *Subsidiary board composition:* The boards of closely held subsidiaries have different governance needs than subsidiaries with mixed ownership or parents or standalone banks. For closely held subsidiary boards, formal independence may be less critical than ensuring that the board has sufficient knowledge and experience to perform its oversight role in the context of a global banking organization and that it has sufficient diversity of views and is able to challenge subsidiary management.
14. *Assessing subsidiary board composition:* Parents as well as subsidiaries need to consider whether their current subsidiary board composition is best suited to address the bank's needs, ensure performance, and provide for safe operations.

15. *Subsidiary board committees:* Whether board committees within subsidiaries generate value for the parent or the subsidiary is a matter of debate. If well composed, with sufficient stature and expertise, they can contribute to the overall quality of governance. Yet many serve only to comply with legal requirements. Parents should review the effectiveness of their audit committees and consider enhancing both their expertise and their independence.
16. *Board evaluations:* Board evaluations are increasingly encouraged by regulators and considered best practice. Parents as well as subsidiaries should consider conducting subsidiary governance evaluations to assess and enhance their governance practices.

Subsidiary governance from the perspective of the supervisor

17. *Modeling subsidiary governance on parent governance practices:* There is a tendency to model regulatory requirements for subsidiaries on the requirements for larger parents. Transposing requirements for standalone banks may not be successful unless the requirements are adapted and made proportionate to the subsidiary bank.
18. *Proportionate response or risk-based approaches:* Supervisors should apply a risk-based approach to governance, with requirements that are proportional to the nature, scale, and complexity of the subsidiary's business and risks.
19. *Mandatory versus voluntary:* A balance needs to be struck between mandatory rules and voluntary or principles-based approaches to governance. The approach will also depend on the local business and legal culture and traditions.
20. *Efficient and effective governance regulation:* Supervisors should aim to develop governance rules that are effective but not unduly burdensome. Though the 2007–2008 crisis may have shown the need for more regulation, less but well-designed regulation, enforced through efficient supervision, should remain a goal.
21. *Dialogue between supervisors and banks:* Communication between supervisors and banks helps convey supervisor expectations. It also helps supervisors craft more effective rules and avoid the unintended consequences of poorly designed regulation.
22. *Dialogue between host and home countries:* Dialogue between host and home country authorities is necessary for effective supervision in globalized markets. There is room for improvement in the function of supervisory colleges and memoranda of understanding.
23. *Dialogue between local regulators:* Better in-country dialogue, information sharing, and cooperation between regulatory institutions should enhance supervisor effectiveness.

Overview: Introduction and Background

The 2007–2008 financial crisis was unusual in both origin and effects. Supervisors, who are traditionally attentive to the potential for contagion from banks that operate across borders, ordinarily focus their concern on the bank subsidiaries in less-developed foreign jurisdictions. However, the 2007 crisis started in the United States and then spread from there through developed financial markets and on to emerging markets and post-transition economies. In this highly unusual crisis, powerful parent banks were viewed as a potential source of risk to their subsidiaries, rather than the other way around. This publication grew out of reflection on that crisis and how governance of bank subsidiaries, in particular the subsidiaries of banks that operate across borders, may lessen the impact of such an event in the future.

“Home country supervision of foreign subsidiaries is no longer the reassuring thing that many thought it was before the crisis erupted.”

John Plender, Contributing Editor for the Financial Times,
Member, IFC Private Sector Advisory Group

The crisis demonstrated that contagion, like a virus, can travel in any direction. In 2007, it spread through a network of globally interlinked financial institutions and was accelerated by the use of financial instruments whose potential for spreading risk was not fully appreciated. Banks in smaller countries were spared much of the turmoil because of their reliance on the bread-and-butter banking business of deposit taking and lending.

Nevertheless, some subsidiary banks and host country supervisors found themselves in an uncomfortable situation as parents sought to shore up their balance sheets through intragroup transfers. This was a significant concern particularly in smaller countries where the subsidiaries of large international bank groups were systemically important.

Moreover, while home country supervision provided a level of comfort to host countries during good times, it became clear that the interests of home and host country supervisors could diverge in times of crisis. Supervisors have an obligation to

The 2007–2008 crisis showed that the subsidiaries of large foreign banks were potential vehicles for contagion.

The crisis also showed that home and host country regulators’ interests could diverge when they needed to prop up a systemic bank at the expense of another member of the banking group.

protect the stability of their home markets and act in the best interests of their country. During a crisis this could require propping up a weak but systemically important parent at home at the expense of a strong foreign subsidiary. At the same time, a host country could find it necessary to restrict funds outflows that might threaten the stability of the local banking market.

It used to be that the parents were concerned about the health/prudence of the subsidiaries. During the crisis, that was reversed and the subsidiaries often were concerned—and felt uninformed—about what was happening at the parent level.

IFC Corporate Governance, Lessons Learned Series

In 2010, IFC and the European Bank for Reconstruction and Development (EBRD) raised concerns regarding cross-border intragroup transfers. In 2012, they discussed those concerns in an IFC/EBRD policy brief on bank governance in Southeast Europe (IFC and EBRD 2012). The policy brief highlighted how reliant some small countries are on the subsidiaries of foreign banking groups and showed, for example, how in 2009 foreign-owned banks held an average of 87 percent of bank assets in the Southeast Europe region (IFC and EBRD 2012). Where foreign-bank subsidiaries have a significant impact on systemic stability, they become a concern for host country supervisors (Allen, Gu, and Kowalewski 2013). The concern is even larger in countries where businesses rely principally on banks to meet their financing needs (Allen et al. 2011).

What does this have to do with corporate governance? While the first response in SEE countries to stem outflows was through regulatory intervention, some parties soon proposed that changes to subsidiary governance should be part of the longer-term solution. The broad thrust of the suggested remedies was to make subsidiary boards more attentive to the interests of the subsidiary and local stakeholders, particularly depositors and creditors. Some specific recommendations included requiring a minimum number of independent members and local representatives on the board. Some more forceful recommendations included requiring certain board members to represent depositors and changing company law to create a legal fiduciary duty of board members to stakeholders.

Proposed
changes to
governance
would make
foreign
subsidiaries more
accountable
locally.

A. The reach of foreign banking networks

The concerns discussed in the SEE policy brief have broad relevance. The foreign bank presence in Southeast Europe approaches 90 percent of domestic banking assets. This may be an extreme, yet banking assets held by foreign banks commonly approach 50 percent in many Latin American countries as well as in Central and Eastern Europe (Cardenas, Graf, and O'Dogherty undated). (See Box 0.1.)

Box 0.1: Measures of Cross-Border Banking and Consolidation

- The five largest global banking groups controlled more than 16 percent of global banking assets in 2008.
- France, Germany, the United Kingdom, the United States, Switzerland, and the Netherlands dominate cross-border banking, holding about half of cross-border banking assets.
- Fifty percent of cross-border banking liabilities are accounted for by U.S., U.K., French, German, Japanese, and Netherlands banks.
- The percentage of foreign assets in total assets for major banks in Europe is 82 percent for Deutsche Bank, 64 percent for Santander, 62 percent for UniCredit, 41 percent for BNP Paribas, and 29 percent for Société Générale.
- Each bank has at least 100 majority-owned subsidiaries, and more than half have over 500 subsidiaries.

Source: Allen et al. 2011.

International banking groups are sizeable institutions, many with networks of hundreds and even thousands of subsidiaries. The largest groups are often systemic at home and can control systemic subsidiaries in host countries (Allen et al. 2011). International banking groups can thus potentially pose a risk across their fields of influence, making questions of bank subsidiary governance broadly relevant.

B. The stabilizing effect of cross-border banking

While the risks of cross-border banking are familiar, we must also acknowledge its positive effects. Cross-border banking can bring modern banking practices, access to capital, and good governance practices to countries where the banking sector may be catching up to global best-practice standards. Foreign banks also can enhance competition and help provide local businesses with better financial services. Furthermore, foreign-

The dominance of foreign banks in some host country financial sectors contributed to the fear of external contagion.

Cross-border banking can have stabilizing effects and support the efficient allocation of resources—even in crisis.

Despite potential risks, cross-border banking brings significant benefits.

bank subsidiaries have been associated with the stabilization of financial systems in underdeveloped countries (Cerutti et al. 2010).

The debate has in the past sometimes unduly focused on the negative spillovers from cross-border banking rather than on its stabilizing effects, which are naturally less visible.

Allen et al. 2011

It is also possible that intragroup transactions can stabilize the parent group and that they are not always detrimental in times of crisis. Though this may contrast with traditional views, Cerutti et al. (2010) suggest that preserving the strength of a banking group by allowing intragroup transactions may ultimately benefit both the subsidiary and the host country.

The ability to allocate funds freely is efficient not only from the perspective of banks, but also for a host country. It can make the group as a whole more stable and protect the bank from shocks in the home country.

Cerutti et al. 2010

Of course, it makes sense to be cautious about unconditional intragroup transfers. At present, there is a lack of internationally agreed cross-border bankruptcy and resolution regimes for banks. And host country supervisors in charge of the safety and soundness of banks as deposit takers may be justified in having doubts as to the repayment of the money borrowed from a local subsidiary by a parent bank or another entity in the group in case of bankruptcy.

In summary, cross-border banking and subsidiary structures have benefits that balance and appear to outweigh the drawbacks, as long as the presence of foreign banks does not become excessive and as long as the stability of the subsidiary is maintained (Allen et al. 2011). Important questions—such as the level at which cross-border banking becomes excessive, what if any ensuing actions could be taken when it becomes excessive, and appropriate limits on intragroup transactions—are outside the scope of this paper.

C. Tools at the disposal of host countries

The changes in subsidiary governance suggested in SEE can be seen as a means to check intragroup transactions that might be detrimental to the subsidiary. Any new governance requirements would be in addition to the tools that supervisors already have at their disposal to regulate intragroup transactions and provide assurances that bank holding companies not abandon host markets in times of crisis.

Such tools include regulatory requirements that restrict parent companies' ability to extract funds (Allen et al. 2011) or limit the deposits and loans that affiliates can make in a parent bank or affiliates. Some supervisors expect local subsidiaries to follow large exposure regulatory limits for interbank placements as well as internal lending limits and procedures.

In times of crisis, local supervisors may also mandate daily or weekly liquidity reporting for interbank and intragroup placement to ensure that no lending to ailing affiliates takes place at the potential cost of depositors and the local deposit insurance fund. In addition, supervisors may mandate capital maintenance agreements that require parents to come to the rescue of their subsidiaries (Eisenbeis and Kaufman 2005). Another form of assurance may be for parents to provide "comfort letters" to assure authorities that they would assist their subsidiary in case of distress.

In the United States, members of a financial group may be obliged to rescue failing peers. Under the "source-of-strength principle" in U.S. law, a holding company must act as support to its subsidiary banks. Moreover, in a bank failure the U.S. FDIC (Federal Deposit Insurance Corporation) may bill the cost of the failure to affiliate or sister banks (Cardenas, Graf, and O'Dogherty undated), if it can be proven that the subsidiary is not truly independent from the parent. Parent companies may thus be found liable to subsidiaries, despite a limited liability structure (Cardenas, Graf, and O'Dogherty undated).

In many countries, such assurances are considered a corporate obligation of the parent bank as an entity of public trust. Failure of an international banking group to meet commitments to a local bank and local supervisors would normally be considered a breach of trust, resulting in serious reputational damage.

A variety of assurances protect host countries against uncoordinated withdrawals and protect local stakeholders.

However, these assurances may not carry much weight in times of crisis.

D. The value of assurances

However, there is no guarantee that assurances will be effective in times of crisis. Comfort letters are essentially voluntary commitments, and mandatory capital maintenance and other support requirements may be difficult to enforce. Thus the expectation of support should not be a foregone conclusion.

“Of course, looked at on a group basis, you would say, “We are responsible as a group.” But when the balloon goes up, [and] the local regulator...has to sort this mess out... every legal argument is likely to be raised that places the responsibility with that local subsidiary, to the detriment of the public and the depositors in that host country.”

Roger McCormick, London School of Economics, United Kingdom

The tenuous nature of support commitments is illustrated by the example of Southeast Europe during the crisis, where supervisors and international financial institutions found it necessary to intervene and stabilize the markets. The European Bank Coordination Initiative, the so-called “Vienna Initiative,” was launched to prevent uncontrolled withdrawal of funds at the height of the crisis just as banks were trying to take liquidity out of the SEE region (IFC and EBRD 2012).

The Vienna Initiative and the joint efforts of national banking supervisors and central banks may be credited with preventing large uncoordinated withdrawals of cross-border bank groups in SEE. It encouraged banks to honor their exposures and to support subsidiaries. In addition, it helped avoid home country bias (EBRD 2011). The Vienna Initiative and the Mexican debt crisis of the 1990s serve to remind us that, while assurances have value, they are not perfect, and that other methods of influencing bank behavior, including through subsidiary governance practices, may be needed.

E. Governance as a defense against crisis and contagion

Supervisors are endeavoring to develop responses that makes a repeat of the dimensions of the crisis of 2007–2008 less probable. The main defense has been prudential regulation, primarily in the form of stricter capital, liquidity, and risk-management standards.

Good governance is expected to support new prudential regulation. Good governance strengthens the way banks operate, which may help soften crises. Good governance is guided and framed by regulatory parameters and enforced by effective and empowered supervisory processes. If institutions have sound governance, they might be more receptive to new regulation.

Better financial regulation has much to accomplish, but cannot alone satisfactorily assure performance of the major banks at the heart of the free market economy. These entities must also be better governed.

Better corporate governance of banks cannot guarantee that there will be no repetition of the recent highly negative experience for the economy and society as a whole. But it will make a rerun of these events materially less likely.

The Walker Review

Yet the effect that better governance will have in preventing or attenuating future crises remains uncertain. It bears remembering that the root cause of the 2007–2008 crisis was a complex interplay of government policies encouraging home ownership, bundled subprime mortgages, the lack of adequate capital among banks and insurance companies, and a global chain of transmission. If governance was not the fundamental cause, it is uncertain how it can be the primary solution.¹

Irrespective of different views on the role of governance in attenuating future crises, all sides agree that better governance is worth pursuing, even if its precise impact is difficult to measure. Though the empirical evidence that links certain governance practices to performance and stability may at times be missing,

¹ Some observers assess the potential to materially attenuate crises as low (Cheffins 2009; Mühlbert and Citlau 2011), while others take the view that good governance may materially reduce the likelihood of future crises (Walker 2009).

Better governance practices are expected to support the implementation of emerging prudential regulation.

Good governance, in turn, relies on a supportive culture and banks buying into the benefits of governance.

the view is that fostering a culture of accountability, transparency, better assessment of risk focus and appetite, due consideration of stakeholders, and rigorous analytical and decision-making practices can benefit not only parent and subsidiary banks but also the financial system.

F. The importance of culture and incentives

Any proposed reforms in governance need to be assessed with the knowledge that good governance is not the inevitable consequence of new requirements or even better legal compliance. Governance practices are molded by the bank's business culture and determined by operational needs and incentives.

Values and culture may be the keystone of [financial institution] governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.

Working Group on Corporate Governance, Group of Thirty

So for example, rules that require having a fixed percentage of independent directors on the board, or separating the chair and CEO roles, or establishing a risk committee, may contribute to good governance on paper, but they can fail in the absence of a strong governance culture and a supportive environment within the bank. For banks to commit to good governance, the bank needs to see governance as part of its value proposition and a means to enhance competitiveness, and not just a tool to ensure financial sector stability.

1. Efforts to Strengthen Bank Subsidiary Governance

Those countries most affected by the 2007–2008 crisis are strengthening their prudential regulation to enhance stability and local accountability. While the approaches are different, the overall intent is to separate traditional banking activities from riskier ones and create arm’s-length relationships between parents and subsidiaries. Some changes require modifying a bank’s governance structures.

The common thread among the changes is to create greater independence among bank subsidiaries and to strengthen local accountability. These changes include greater reliance on boards to monitor operations and risk, the use of independent board members, and the adoption of independent oversight structures such as independent audit, remuneration, and risk committees, among others. These are features commonly associated with the governance of listed companies.

A. Ring-fencing in the United Kingdom

The United Kingdom has introduced significant financial sector reforms with broad implications for governance. The key feature of the U.K. response to the financial crisis is “ring-fencing.” The U.K. Banking Reform Act requires ring-fencing, or separating retail subsidiaries from the riskier activities of other parts of the bank holding company. Ring-fenced entities in the United Kingdom are expected to be legally independent with independent governance, an independent board, and a significant degree of operational and financial independence (Ernst & Young 2012; U.K. Government 2013).

The United Kingdom’s goals of ring-fencing are as follows:

- Make banks more resilient to potential shocks transmitted from affiliated institutions;
- Make problems easier to fix when banks get into difficulties, or in case of bankruptcy and resolution, through a clearer and more distinct legal identity;
- Ensure that taxpayers not bear unacceptable risk in the event of insolvency;
- Reduce the severity of future financial crises by limiting the potential for contagion; and

All major banking markets are working on regulation that touches on parent and subsidiary governance.

The focus in the United Kingdom has been “ring-fencing” to create arm’s-length relationships between parents and subsidiaries and insulate local banks against external shocks.

A variety of governance reforms were considered as part of a thorough consultative process.

- Protect the principle source of financial services for consumers and small and medium enterprises that constitute the backbone of the U.K. economy.

Prior to the Banking Reform Act of 2013, the U.K. government considered different options for subsidiary governance. The Independent Commission on Banking, established in 2010, produced the so-called Vickers report in 2011 (Independent Commission on Banking 2011), followed by a U.K. Treasury white paper published in 2012 (U.K. Government, HM Treasury 2012), and release of the final report on banking from the U.K. Parliamentary Commission on Banking Standards in 2013 (U.K. House of Lords, House of Commons 2013).

Not all proposals made during the lead-up to the Banking Reform Act made their way into the new legislation. But it is worth noting some measures that were considered:

- Creating banking culture and governance arrangements distinct from the parent;
- Requiring that board members act in the interests of the ring-fenced bank;
- Requiring that board members protect the ring fence;
- Having an independent chair of the board;
- Requiring a majority of directors to be independent;
- Allowing no more than one director of the ring-fenced bank on the parent board;
- Allowing no more than one-third of board members to be representatives of the rest of the group;
- Requiring the ring-fenced bank to have its own risk function;
- Requiring the ring-fenced bank to have its own remuneration function;
- Requiring the ring-fenced bank to demonstrate its independence;
- Requiring disclosures to be made as if the bank were listed; and
- Having disclosure requirements according to the U.K. Corporate Governance Code, as well as other regulatory and accounting requirements.

B. Developments in the European Union

Just over a year after the Vickers report, the European Commission published the Liikanen report, which also advocated structural separation of riskier banking activities from traditional ones. The report considers certain aspects of bank governance.

The Group considers that it is necessary to augment existing corporate governance reforms by specific measures to 1) strengthen boards and management; 2) promote the risk management function; 3) rein in compensation for bank management and staff; 4) improve risk disclosure and 5) strengthen sanctioning powers.

The Liikanen Report

The report points to the failure of boards to rein in excessively risky behavior as a contributor to the financial crisis (Burgis 2012). Its recommendations are directed at the holding-company level, in particular systemically important banks, and do not specifically address bank subsidiary governance, on which it is largely silent.

In 2011, the European Commission published proposals to implement the international standards on bank capital requirements recommended by the Basel Committee on Banking Supervision. The Capital Requirements Regulation (CRR) and the Capital Requirement Directive (CRD IV) include provisions on governance, transparency, and remuneration.

In essence, the CRD IV contains requirements on the nature and composition of management bodies and risk-management arrangements within firms, while the CRR requires banks to make increased disclosures about their corporate governance arrangements. Both apply to subsidiaries as well as groups; however, the principle of proportionality allows banks to take into account the size and complexity of institutions as well as different corporate governance models (Norton Rose Fulbright 2013).

Emerging EU Audit Directives will require audit committees to have at least one and possibly two independent directors with competences in accounting and audit. Thus while the banking rules do not require independent directors on audit committees, audit requirements may make independent directors obligatory.

Emerging regulation in the EU considers issues of bank governance mainly at the holding-company level.

Foreign banking organizations in the United States will have to create intermediate holding companies over their subsidiaries.

C. Subsidiary governance in the United States

The United States already had a form of light-touch ring-fencing (Euromoney 2013), whereby rules protect FDIC-insured banks from losses arising through affiliates. New rules under the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 require foreign banking organizations with a significant U.S. presence to create an intermediate holding company over their U.S. subsidiaries. (See Box 1.1.) Foreign bank subsidiaries are, in turn, subject to Basel III capital, liquidity, stress testing, and other requirements.

Box 1.1: Some Governance-Related Requirements of Dodd-Frank

- Requiring company proxy materials to include shareholder nominees to the board of directors;
- Prohibiting broker discretionary voting on the election of directors;
- Requiring nonbinding shareholder votes on executive compensation (“say on pay”);
- Requiring exchanges to adopt listing standards that demand greater independence for compensation committees and that promote independence among compensation committee consultants, legal counsel, and other advisors;
- Disclosure of justification for having the CEO as chair of the board of directors;
- Requiring two independent directors on the board;
- Disclosures about the relationship between executive compensation and financial performance, and the ratio between CEO compensation and median employee compensation;
- Incentive compensation clawback^a provisions;
- Establishing subsidiary board risk committees; and
- Requiring management and board of directors to govern and control stress testing.

a. Clawback is the recovery of money already distributed.

2. *The Diverse Nature of Bank Subsidiaries*

This section illustrates the variety of cross-border subsidiary banks that exist, and explores the business rationale for different approaches. The conclusion is that subsidiary banks are highly diverse and that a one-size-fits-all approach, particularly if applied through rigid regulation, is not likely to be effective.

A significant challenge in fitting new approaches to subsidiary governance is the great diversity of subsidiary structures in practice. The danger is that some governance practices will not fit the nature of the subsidiary or the needs of the parent. Applied blindly, they may hamper the bank in the achievement of its objectives and hamper supervisors in the achievement of theirs. In a worst-case scenario, well-intentioned but poorly considered governance requirements can foster among banks a culture of formulaic and superficial compliance.

A. Different ownership structures

The main differences in bank subsidiary governance result from different ownership structures. The following are the main ownership/governance structures:

- Wholly owned subsidiaries;
- Mixed-ownership subsidiaries; and
- Listed subsidiaries.

The governance practices of a wholly owned subsidiary differ considerably from those of a subsidiary with multiple shareholders, which, in turn, differ from those of a listed subsidiary.

Multinational bank holding companies choose different ownership structures principally as a function of their international growth strategy. Some multinational banks expand through acquisition, which brings the benefits of buying into an established business. Others grow through greenfield investment and build their foreign ventures from the ground up. Banks will also consider political and economic risks, regulation, and taxation in their choice of approach (Cerutti, Dell’Ariccia, and Martinez 2007).

Of course, legal requirements will be a major determinant. In some countries, there may be no alternative to establishing

The enormous diversity in subsidiary structures resists a single approach to governance.

The governance practices of wholly owned, mixed-ownership, and listed subsidiaries and branches differ considerably.

Though many supervisors prefer subsidiaries over branches, many parents would prefer the freedom provided by branch structures.

a subsidiary. In others, such as Mexico and Poland, systemic subsidiaries of foreign banks must be listed. Listing subjects subsidiaries to the rules of the securities commission and stock exchange, and brings their governance practices up to the standard of listed companies, which are often considered the reference point for good governance.

In practice, subsidiaries and branches are effectively identical, but their structures are clearly distinct. Subsidiaries are locally incorporated companies that fall under the supervision of host authorities and are under the ultimate responsibility of host country regulators. By contrast, branches are typically regulated by their home countries and, in case of failure, are the responsibility of the parent bank. Many factors can influence a parent's choice of whether to establish subsidiaries or branches, and the reasons for the choice are not always evident.

Supervisors often prefer subsidiaries over branches because of their insulating effect on risk and because they allow a greater level of control in the host country. However, Cerutti, Dell'Ariccia, and Martinez (2007) suggest that regulators should favor branches, which have direct access to financially strong parents in times of crisis.

From the perspective of the parent bank, the choice between foreign subsidiaries and branches largely reflects business decisions and local regulatory requirements. Though some parents may prefer the simplicity and flexibility afforded by a branch, local rules may require them to establish subsidiaries in order to operate.

Subsidiaries that are established purely to meet legal requirements may be particularly vulnerable to superficial compliance with local governance rules because of conflicting perceptions. Whereas in the original view of legislators the subsidiary is a truly independent entity, the parent's business strategy may have envisioned the subsidiary as a closely integrated operation.

Branch governance is an issue that has received scant attention in host countries, because the branch is governed by the rules of home country regulators. However, in Europe, the scrutiny of branches by host supervisors increased after the crisis and after problems emerged in branches of Icelandic banks in the United Kingdom and the Netherlands. EU legislation has since introduced the concept of systemic branches, which are subject to additional host country oversight.

B. Different levels of board autonomy and independence

Greater board autonomy and independence at the subsidiary level is clearly the flavor of the moment. Supervisors have high expectations of the autonomous and independent board.

Yet autonomy can present an ongoing tension and a dilemma for the parent, the local subsidiary, and supervisors. The dilemma results from the parent's obligation to control and respond to its global risk and business strategy. To do so, it must have certain systems and consistencies across its network. The question is, how does it do that, and with what tools—and how does it frame the responsibilities of the local subsidiary? How much centralization is too much, and how is that balanced with local responsibilities? These are issues that need further study.

The main issue related to corporate governance is to find balance between the governance practices of the parent bank and local regulation. When defining the balance we must always have in mind that the board of the parent bank has the overall responsibility for adequate corporate governance across the group and ensures that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

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In any event, it is not certain that highly autonomous and independent boards are best suited to all types of subsidiaries. Practical experience suggests that imposing a single governance standard on a diverse set of subsidiaries may have a negative impact. Achieving the proper balance between central control and local autonomy will require some level of tailoring, depending on the operation and the local environment.

Greater autonomy and independence of subsidiary boards needs to be balanced by the need for central control, particularly in the areas of risk management and strategy.

Business models can be categorized broadly as centralized or decentralized.

C. Different business models

The above sections suggest the importance of the choice of business model for the governance of the subsidiary. The different business models can be broadly categorized as either centralized or decentralized.

The choice of the legal form of cross-border service provision is not the only variable to assess differences across banks' business models. Rather, the main differences arise from the degree of integration of the risk management of the group as a whole and from the funding and liquidity models.

. . . [N]otwithstanding the differences between the funding and liquidity practices of cross-border banking groups, they can all be categorized broadly into two main models, either centralized or decentralized. . . .

Liikanen Report

At the heart of the difference between centralized and decentralized banks is their approach to funding. Under a decentralized model, the local affiliate is more autonomous in its funding strategy. For example, Spanish banks, having grown through acquisition of local banks, particularly in South America, are known to be decentralized. Under a centralized model, foreign affiliates may rely more extensively on intragroup funding (Allen et al. 2011). While this simplified view may be overly schematic, it is a useful approach to illustrate the differences in governance practices that result from different business strategies.

D. Different governance structures

Different business models determine different governance structures and practices. The decentralized business model can be associated with more independent governance structures, including an autonomous board, often with independent directors, and localized strategy and risk management. Under the centralized model, the parent and subsidiary are closely integrated and governance may be more focused on ensuring that the local subsidiary is in compliance with the strategy and policies that are set at the parent level.

Boards of centralized subsidiaries have been described as serving principally as conduits for instructions from the parent to the subsidiary and have been the object of criticism. A critique of subsidiary boards in the SEE region includes the following (IFC and EBRD 2012):

- Infrequent board meetings, held only in response to law or regulation;
- Boards that focus narrowly on implementing decisions from the home office;
- Boards composed exclusively of or dominated by insiders;
- Parent bank executives as chairs of subsidiary boards; that is, limited capacity for independent judgment; and
- Board members flying in sporadically without having an understanding of the local language, culture, or business environment.

Such practices reflect a tension between the views of parent banks and the expectations of supervisors and policymakers about the proper role of subsidiary boards and subsidiary governance more generally. For many centralized banks, the subsidiary board is a tool to ensure that central goals and objectives are being pursued and that the subsidiary complies with the policies established by the parent. On the other hand, supervisors increasingly expect that subsidiary governance will approach the standard of governance for a standalone enterprise.

In the end, the different business models, when examined in detail, suggest that no single governance approach can respond well to the needs of different types of banking organizations. Many subsidiaries do not operate as standalones, nor is it certain what measures (for example, mandatory independent

The choice of centralized versus decentralized models is a fundamental determinant of the way the governance duties and prerogatives will be shared between the parent and the subsidiary.

No single governance approach can respond to the circumstances of different types of bank subsidiaries.

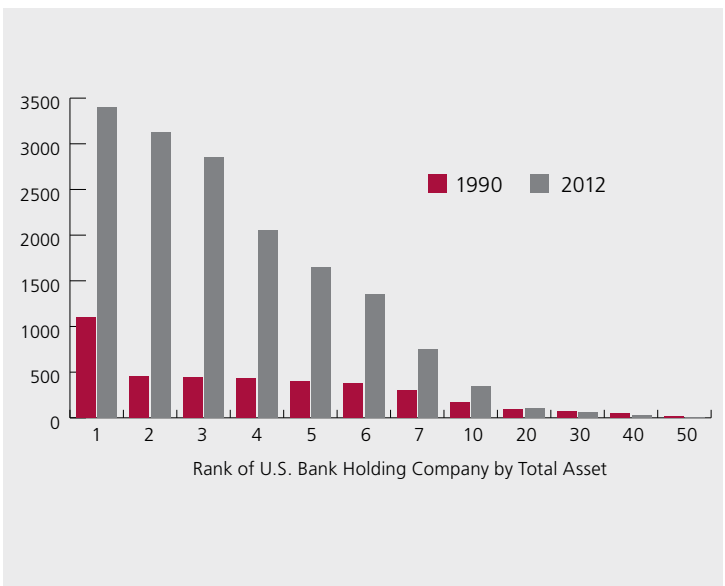
Large and complex banking networks defy simple oversight.

directors) improve governance in practice. The challenge will be to see what measures can contribute to better governance and risk management and how such practices can be structured to complement and reinforce the parent’s strategic and operational goals.

E. Different levels of complexity

Many multinational banks have extensive networks. The size and complexity of international banking operations are receiving more and more attention. Evidence shows that bank holding companies are increasingly large and complex and, arguably, too complex to permit easy oversight of their operations (Herring and Carmassi 2010). For example, Citi has nearly 2,500 subsidiaries that operate in over 80 countries (Avraham, Selvaggi, and Vickery 2012). Some European banks have equally large branch and subsidiary networks.

Figure 2.1: Number of Subsidiaries in U.S. Top-50 Bank Holding Companies



Source: Cetorelli and Goldberg, Federal Reserve Bank of New York 2014.

Even modest-size international banks can be expected to have in excess of hundreds of subsidiaries. (See Figure 2.1.) Executives in bank holding companies faced with this sort of complexity naturally struggle to keep track of subsidiaries, much less ensure that subsidiaries comply with both parent and host country governance requirements. (See Box 2.1.)

Box 2.1: Risks Associated with Highly Complex Bank Holding Companies

In July 2014, U.S. Senator Elizabeth Warren questioned Janet Yellen, chair of the board of governors of the U.S. Federal Reserve, in connection with JP Morgan's "living will," a contingency plan designed to assist in resolution and recovery planning. Warren's concern was that the number of subsidiaries of holding companies was so large as to make timely and orderly resolution impossible. As part of her testimony, Yellen noted that JP Morgan currently had an astonishing 3,391 subsidiaries worldwide.

Warren's line of questioning reinforces the need for parents to understand complex structures and risks associated with highly complex organizations composed of thousands of subsidiaries. The implication is that regulated entities should have the capacity to know their organization. The context was within the discussion of living wills, but the observation that complexity may serve to obscure risk is equally valid for a bank operating on a going-concern basis.

Source: Video of U.S. Congressional testimony of Federal Reserve Chairman Janet Yellen, as questioned by Senator Elizabeth Warren on July 15, 2014: <http://cs.pn/1w1ric2>.

Many observers view complexity as posing a risk in itself (Basel 2010). Size can bring economies of scope and scale, though complexity may hamper monitoring and governance (Avraham, Selvaggi, and Vickery 2012). How to manage such complexity and properly govern subsidiaries from the perspective of the parent is raising increasing interest among banking groups.

Modest-size banking groups can have in excess of hundreds of subsidiaries, with large ones in excess of thousands.

Such complexity potentially contributes to risk.

F. One size does not fit all

The phrase “one size does not fit all” has become old and clichéd in the governance world. Yet it remains true as ever when it comes to the governance of subsidiary banks. The variety of subsidiaries and the circumstances they operate under defy simple cookie-cutter solutions. This section has sought to describe some of the factors that explain different governance practices and show that diverse types of subsidiaries call for different approaches to governance. (See Box 2.2.)

Box 2.2: Main Determinants of Different Governance Practices

Legal requirements:

- Country of incorporation
- Regional or international agreements

Ownership structure of the subsidiary:

- Wholly owned
- Multiple shareholders and percentage ownership of the parent
- Listed subsidiary

Parent structure:

- Holding company
- Parent as a bank

Historical context (the way the subsidiary was formed):

- Resulting from a new establishment
- Resulting from an acquisition or merger of existing entities
- Buy-in, buyout
- Consortium

Parent business strategy:

- Centralized liquidity (better exploitation of scale economies)
- Localized liquidity

This being said, there are some general reflections that may help parents, subsidiaries, and supervisors improve governance and better achieve their goals. The thrust of the following sections is that parents need to enhance centralized oversight, while subsidiaries need to enhance local governance practices. Supervisors should refrain from making blanket requirements that are either untested or might be ill-suited to the variety of subsidiary banks that exist.

Different ownership structures, levels of board autonomy, business models, and governance structures all suggest that there is no one single approach to sound subsidiary governance.

Some general guiding principles of behavior may, nevertheless, help parents, subsidiaries, and supervisors.

3. *Subsidiary Governance from the Perspective of the Parent*

Many international banks find it difficult to track their subsidiaries because of the sheer number of subsidiaries in their portfolios. Often, these subsidiaries have different business models and governance policies and operate in different jurisdictions.

An opaque portfolio of subsidiaries is a “black box” with the potential to obscure governance risk. For this reason, the Basel Committee requires the board of the parent company to have overall responsibility for adequate governance across the group and to ensure that functioning governance mechanisms are in place. .

A. Systems for tracking governance

Potential risks need to be assessed and understood. A first step for parent banks with large and complex portfolios is an initial assessment of their capacity to exercise effective governance over the subsidiary network. The second step is to develop systems for tracking governance practices and for implementing consistent subsidiary governance throughout the network. Systems should allow the parent bank to do the following:

- Have an inventory that establishes the precise number of subsidiaries;
- Oversee a portfolio of subsidiaries that could range into the hundreds or even thousands;
- Generate real-time information regarding the bank’s structure;
- Assure itself that subsidiaries are in compliance with both parent policies and host country governance requirements, including the following:
 - director appointments,
 - officer appointments,
 - minutes of board meetings;
- Track who directors are and how they are selected;

The parent bank is responsible for setting and tracking the governance practices across the group and ensuring that appropriate governance mechanisms are in place.

Best practice suggests that parents be capable of accurately tracking subsidiary governance.

Such tracking
can be necessary
to meet
regulatory
requirements.

- Track the availability of corporate secretaries, who are responsible for providing policies on proper governance;
- Provide information for reporting to regulators, management, and directors; and
- Ensure consistent implementation of policies and procedures.

A good practice is to have a single central database for tracking subsidiaries. It is critical to ensure that the information in this database is well-maintained. This requires systems that are capable of being updated in real time from various locations across the world. Well-designed information technology solutions can make this possible through Web-based intranets. Alternatively, systems can be purchased from external providers.

Such systems will likely become more important as rules for prudential supervision evolve. Systems should help comply with the expectations of the Basel Committee Principles, which suggest that the bank's internal audit periodically review practices to assure the parent board that sound governance is in place (Basel 2010, paragraph 118). Systems are also useful for reporting to supervisors on the structure of the group (Basel 2010, paragraph 119). As with all systems, their efficacy needs to be verified. The internal audit function of a bank can review the systems for tracking subsidiary governance. (See the illustration in Box 3.1.)

Box 3.1: Reducing Complexity and Cost through Subsidiary Rationalization

An additional benefit of centralized tracking is to better regulate the creation and dissolution of subsidiaries. Many bank holding companies experience an unnecessary proliferation of subsidiaries. Many subsidiaries outlive their intended purpose. For example, holding companies may accumulate subsidiaries that were established to fulfill a short-term need (such as a real estate transaction) but are not dissolved after the transaction is completed.

Inactive subsidiaries incur legal and associated costs. Tracking the subsidiary lifecycle, and closing down inactive subsidiaries, has been shown in practice to reduce complexity and unnecessary procedures and lead to significant cost savings.

B. Uniform policies and guidance on governance

Directors and subsidiaries can benefit from uniform written guidance (guides, manuals, or policy statements) on good governance. Good governance practices in subsidiaries can be modeled after standalone company governance, with adjustments made to take into account the nature of the subsidiary and the specifics of the local market. (See Box 3.2.)

Box 3.2: Examples of Areas where Guidance is Helpful

Role and expectations of directors:

- Fiduciary responsibilities to the subsidiary
- Responsibilities toward stakeholders (other than shareholders) and how such responsibilities are exercised in practice
- Parent's expectations of the subsidiary board
- Dealing with potential conflicts between parent and subsidiary interests

Specific tasks of directors:

- Distinction between board oversight and governance versus management of the subsidiary
- Specific responsibilities regarding strategy, risk management, and control

Board composition:

- The importance of active and engaged subsidiary directors
- Expertise needed by directors
- Skills needed for directors

The role of and potential need for independent directors

Processes for director nomination

Proper board size

Evaluating board effectiveness

The parent bank also needs to develop uniform policies and guidance for subsidiary governance.

Such policies are more effective when properly assimilated by local subsidiary boards and executives. They should not be mechanically exported from the parent bank to the subsidiary but rather considered and endorsed locally.

The parent also must consider the human element. Subsidiary directors generally are trained and experienced people, but they may lack expertise in governance. Thus they may benefit from induction training and access to expert advice, possibly

Depending on the bank's size and complexity, it may benefit from establishing a dedicated subsidiary governance unit.

from corporate secretaries,² who can help them resolve their governance questions. It may also be helpful to provide a network of experienced directors who can serve as mentors.

C. Parent-level governance unit

In multinational banks with large numbers of subsidiaries or complex governance structures, there is merit in creating a governance unit at the group level to track and promote good governance throughout the organization. Such a unit could be located within the office of the corporate secretary, the office of the chief legal counsel, or elsewhere.

The model described in Box 3.3 comes from a centralized bank and may not be the most appropriate model in all organizations. Nevertheless, having a subsidiary governance unit dedicated to setting governance standards within large bank holding companies is an idea that merits consideration regardless of the business model of the bank.

² Some countries have limited experience with corporate secretaries, who may be viewed as fulfilling only a secretarial function. The corporate secretary is a highly trained professional, often a lawyer, with legal training in the detailed aspects of governance. Corporate secretaries are often certified by and affiliated with professional associations.

Box 3.3: Staffing of a Subsidiary Governance Unit within the Parent

Leadership:

- Appointment of a fulltime subsidiary governance officer (SGO)

Qualifications:

- The SGO may have a background as a lawyer and report organizationally to the parent bank's corporate secretary

SGO's mission includes:

- Leading the team
- Creating a center of expertise in the bank for subsidiary governance
- Maintaining appropriate enterprisewide subsidiary corporate governance policies
- Promoting corporate governance best practices in subsidiaries
- Encouraging the creation of a strong governance culture
- Working with an internal bank subsidiary governance and oversight committee that coordinates policies and practices throughout the subsidiary network
- Reporting to the parent bank board

Staffing and competencies of the subsidiary governance unit:

- Fulltime staff dedicated to performing corporate secretarial and subsidiary governance duties
- Professionals skilled in the corporate secretarial function:
 - lawyers,
 - paralegals
 - professional corporate secretaries

Source: Adapted from Allgood and Chartier.

D. Proportional governance

Experience suggests that subsidiary governance practices should be proportional to the nature, scale, and complexity of the subsidiary's business and risks. On the one hand, they must be consistent with the principles adopted by the parent and contribute to effective oversight by the parent board. On the other hand, governance practices must be aligned with the size and nature of the subsidiary and with local requirements.

A risk-based assessment may help the parent decide which subsidiaries are of greatest concern and help the parent develop an adapted and proportional approach. A risk-based approach is similar to what internal auditors or bank risk management might use to assess systems or loans. (See the case example in Box 3.4.)

Subsidiary governance can be guided by a risk-based approach.

Box 3.4: Identification of Risk Levels of a Regulated Company

A large multinational bank adopted a risk-based approach to determine where to place individual subsidiaries on a spectrum. It defined different categories of subsidiaries, with each category corresponding to a different level of risk. The categories were defined using criteria similar to those used by internal risk and audit functions, including financial tests and regulatory status.

Based on this categorization, the bank adapted governance standards to match the risk profile of the subsidiary. The standard of governance varied regarding the need for independent directors, the seniority of group management on the subsidiary board, the types of materials that were sent to the board, and the extent to which the board was to consider issues such as risk management, internal audit and compliance, and so on.

E. Centralized versus localized risk management and control

The groupwide responsibility of the parent board for corporate governance is complemented by a groupwide responsibility for risk management. Risk management and control are complex and technical functions that we will not discuss in depth in this short publication. Nevertheless, the essential message is that a parent needs to strike a balance between central oversight and local accountability.

Subsidiary governance is ultimately about balancing the need for parental oversight with local accountability. While subsidiaries cannot operate in isolation from the group and must take into account the direction established by the parent, ultimately it is the responsibility of the subsidiary board and management to ensure that the direction is implemented in a way that is tailored to the subsidiary's needs, including local legal and regulatory requirements, and that it is in the best interests of the subsidiary to follow that direction. In discharging these responsibilities the subsidiary board and management will appropriately take into account the value that is derived by the subsidiary from being part of the group, but blind deference to the parent's wishes is an abdication of the board's responsibilities.

Antonella Deo, Manulife, Canada

Parents need to strike the proper balance between central oversight and local accountability.

Centralized control structures ensure that the parent has a groupwide view of risk. Centralized oversight is enhanced if the subsidiary board is attentive to the needs of the central control function and committed to ensuring the quality of organization-wide systems. In fact, central risk and control functions rely critically on local expertise to be effective. Thus the integration of local input into centralized controls should be an important aspect of the subsidiary board's work.

Prominent proposals include a clearer separation of management and control functions. Matrix structures can maintain the independence of local controls from local management. In reporting to subsidiary management, subsidiary internal audit staff may also be required to report directly to the chief internal auditor of the parent bank. A chief internal auditor may, in turn, report to the audit committee at the parent level. Also, it is best practice for internal audit in regulated subsidiaries to be required to report directly to the subsidiary board, so their views are not filtered through subsidiary management.

Since the parent board needs to be aware of material risks and issues affecting the bank as a whole, it is important that communication links exist for conveying information to the parent board and for escalating issues from the subsidiary board. The responsibility for ensuring uniformity of practice and the efficacy of the whole system remains with the parent, while accountability remains local.

Central control functions are essential for a groupwide understanding of risk.

These central control functions must be complemented by controls on the subsidiary side.

4. Governance from the Perspective of the Subsidiary

There is a perception that subsidiary banks need to close the gap with standalone banks.

In reality, most subsidiaries cannot be governed as if they were standalone banks, without causing major disruption to the overall cohesion of the banking group structure and operation.

There is a perception, particularly among regulators, that subsidiary governance practices should be modeled on the governance practices of standalone banks. In principle, this should be possible. The advantage is that there is abundant experience with standalone governance, and much written guidance on good practices is available. Yet standalone governance in subsidiaries is not generally supported by banks.

The reality is that you cannot effectively operate every subsidiary as if it were a standalone bank. It's not practical and business would grind to a halt if we did.

There are benefits to the subsidiary in operating as part of a group. It is not the role of the subsidiary board to operate in isolation from the group.

Subsidiary management should participate as appropriate in developing group strategy, policies and controls. These should form the basis for developing the subsidiary's own strategy, policies and controls, tailored as necessary to take into account the legal and regulatory requirements applicable to the subsidiary.

Antonella Deo, Manulife, Canada

As seen in prior sections, subsidiary banks are a heterogeneous group. Many are closely integrated into the parent structure and have governance practices that more closely resemble those of family businesses than listed enterprises. For many, the full menu of governance practices may not be necessary where certain critical functions are provided by the parent.

Thus expectations for subsidiary governance need to be adjusted to the nature of the subsidiary. In addition, the justification for better subsidiary governance needs to consider its capacity to create value for the bank.

Subsidiary boards create value for subsidiaries, the parent company and the group.

María Mercedes Ibáñez, Sociedades Bolívar, Colombia

This section identifies the essential factors that distinguish subsidiary from standalone governance and characterize practices that may be specifically suited to subsidiaries. The subsections address the following governance issues specific to subsidiary boards:

- A) To whom does the subsidiary board owe its duty of loyalty, to the parent or the subsidiary?
- B) Does the subsidiary board have legal obligations to stakeholders, such as depositors, creditors, or the country in which it operates? If not, then how is responsibility to stakeholders exercised?
- C) Should a subsidiary board have any role in strategy, or is this an exclusive function of the group?
- D) What is the role of the subsidiary board in the internal controls that are usually exercised at the center of the parent?
- E) Is there a need for independent directors and independent thinking on a subsidiary board?
- F) What is the proper profile for a subsidiary board director, and how should banks go about nominating directors?
- G) Does a subsidiary benefit from having committees typically associated with a standalone?
- H) How do you go about practically improving subsidiary board governance?

It is essential to adapt governance practices to the nature of the subsidiary.

Typically, company law requires boards to act in the interest of the company and in some jurisdictions includes explicit obligations to its shareholders.

In practice, the interests of the parent and the subsidiary can conflict.

A. The board's responsibilities to the parent versus the subsidiary

Directors may confront situations that challenge their loyalty to the parent. From a narrow company-law perspective, directors typically owe their duties to the company. In addition, the laws of different countries may include explicit obligations to act in the interest of shareholders.

Banks are special cases, since there is an expectation that they will act responsibly and not undertake undue risks that could endanger the health of the bank or the stability of the financial system. This implies that subsidiary boards may be obliged to act against the interest of the parent if an action could have a negative effect on a subsidiary.

What should be the position of the directors of the subsidiary company, confronted with a conflict with the parent or with other group entities? On the one hand these directors are entitled to implement the group's policies, even if these have negative effects on the financial position of the subsidiary. But if they dutifully execute orders that are likely to exceed the subsidiary's financial capacity and lead to its default, they should refuse, and if needed, quit, lest they would be held liable.

Eddy Wymeersch, Member, IFC Private Sector Advisory Group,
Ghent University, Belgium

Parent interest may harm a subsidiary in a variety of ways, some of which, such as intragroup transfers, have already been mentioned. Other less visible ways might include requiring a subsidiary to make a loan to the affiliate of a home country client operating in a host country, booking loans in different parts of the group for accounting purposes, low-interest loans, uncollateralized liquidity pooling, pricing decisions for shared services that the group performs for the subsidiary, and so on.

Differences between parent and subsidiary interests may also arise in the area of human resources. For example, a groupwide hiring freeze may affect subsidiaries indiscriminately. Or subsidiaries may be forced to employ executives or staff based on parent needs rather than the needs of the subsidiary. Some practices may affect minority shareholders by distributing dividends in such a way that all shareholders do not participate equally.

It may be difficult to understand the limits of loyalties and to achieve the correct balance between the subsidiary as an integrated operation versus an autonomous entity with obligations that extend beyond the parent. No standard on subsidiary governance practices is available to serve as guidance, and the questions are effectively decided on a case-by-case basis. The issue of the types of situations that arise when subsidiary boards have conflicts, and how board members address them in reality, requires further examination.

In the meantime, the subtlety of the issues and the judgment required in making parent-versus-subsidiary decisions suggest that parents need to dedicate more attention to the issue of subsidiary governance. They also need to provide more training to both directors and executives on how to act when the interests of parent and subsidiary diverge.

B. Directors' obligations toward stakeholders

To whom the board of directors owes its loyalty (the company, its shareholders, or its stakeholders) has been a matter of heated debate for many years, and the discussion does not seem to be going away. In principle, there is agreement that banks should be governed in such a way as to take stakeholder and broader interests into account. Where differences in views emerge is in how this responsibility is to be exercised in practice.

Banks are different from generic companies in that banking is a highly regulated industry with important social and economic impacts. For this reason, the state requires banks to have a license to operate. As a consequence of the special role of banks in the economy, the supervisor's perspective on bank governance is that it is primarily to safeguard the promises made to depositors and debt holders, and only secondarily a tool to safeguard the interest of owners.

Beyond this particularity, the stakeholders in banks are numerous (depositors, debt holders, the government as both insurer of deposits and residual claimant on systemic externalities). And they are large—over 90 percent of the balance sheet of banks can be in the form of debt (Avraham, Selvaggi, and Vickery 2012).

A balance needs to be struck between some level of autonomy for subsidiaries and the needs of the group.

Banks have numerous stakeholders that help maintain the continuity of essential economic functions.

The board's obligation is to take into account the legitimate interests of stakeholders while pursuing the interests of the bank.

We must remember that there is a very strong public good dimension in banks. There is a need to protect depositors; also to protect bondholders; and to protect investors. There is also a need to maintain the continuity of essential economic functions. Within banks, that responsibility lies mainly with the board of directors.

Leo Goldschmidt, Member, IFC Private Sector Advisory Group

The legal basis for acting in the interest of stakeholders is indirect under company law. The OECD (Organisation for Economic Co-operation and Development) Principles as well as the Basel Committee Principles for Enhancing Corporate Governance are important reference points that are representative of developed-country practices. Both are careful to distinguish between the legal duty the board has to *act in the interest of the company* and its shareholders and the duty of the board to *respect* the legitimate interests of other stakeholders and to *take those interests into account when making decisions in the interests of the bank*. While the Basel Principles recognize that the formal responsibilities of a bank to its shareholders, depositors, and other stakeholders vary across jurisdictions, they do not contain any generalizable legal obligation to act in stakeholders' interests.

Rather, the legal obligation of the bank board is more typically expressed as a duty to act in the interest of the bank and enhance its value as a business. A corollary is that the board has an obligation to manage the bank in a sound and prudent fashion and to protect customer interests, because customers are an essential part of the bank's franchise, and because protecting them is not only in the interest of the bank but in all likelihood crucial to its survival.

The obligation that a bank board has toward supervisors is different again. The board's obligation is to ensure compliance with rules, laws, and regulations, while there is no explicit duty of board members to act in the best interest of supervisors or for the bank to stabilize or maintain the health of the local economy or the financial markets.

My loyalty is to the shareholder. I don't think that I owe my loyalty to the customer.

Customers are important because they are part of the franchise, but I don't owe my loyalty to them in the same way that I don't owe my loyalty to the regulator. They are like the policemen that ensure that I comply.

But, that doesn't mean my loyalty is blind. I can give serious consideration to the stakeholder's view. It all boils down to the director's professionalism and competence. No amount of rules will help in their absence.

John Law, Independent Director, BNP Paribas (China) Ltd.

Existing practices may thus leave open the possibility of the board acting against the interests of depositors or other stakeholders if these are contrary to the interests of the bank. Bank and stakeholder interests can and do conflict. This was recognized during the crisis in Southeast Europe when government intervention was needed to stem uncontrolled funds outflows that were clearly against the interests of the local depositors and economy. Boards and good governance practices by themselves were not sufficient to protect stakeholder interests.

One solution is to trust in the capacity of a well-informed and competent subsidiary board to strike a balance between the interests at stake. However, little guidance is available to boards on how to make tough decisions or how to find the correct balance, particularly when the bank is under duress. In such situations, subsidiary board members may find it quite difficult to protect the interests of stakeholders when those interests imply a significant cost to the parent bank.

Thus current board and governance practices may have limits to promote stakeholder interests, absent a change in accountabilities as prescribed in legislation. Suggested strategies for making boards' duty to depositors and debt holders more explicit include 1) changing their accountabilities as prescribed in legislation, or 2) stipulating a specific board duty to depositors or debt holders (Mülbert 2010). Another alternative may be the development of codes of best practice for subsidiary boards.

Governance practices may have limits regarding the extent to which they can be expected to protect subsidiary stakeholders.

It is essential that the parent maintain control of the strategy of the group.

C. The board's role in strategy

Strategy setting is arguably the most important function of a board. The development of strategy is a tightly guarded domain at the top of the organization. The *implementation* of strategy occurs at lower levels of a group structure.

Strategy implementation occurs through a variety of functions: how risks are planned for and controlled; considerations on the capacity, staffing, and resources of the bank; the audit and control (risk management and compliance) functions; and so on. Implementing strategy also includes the processes and structures used to monitor progress on its achievement.

Despite its stature as the highest authority within the subsidiary, a subsidiary board is of comparatively lesser significance within the group. It is unlikely for a parent board to cede control of its most essential function, especially when subsidiary board members may be more operationally oriented and less experienced with strategy issues than parent board members.

The parent board wants the subsidiary board to carry out strategic policy, not to create strategy or policy.

Regulators do not want to hear that. They want to hear that the subsidiary board formulates policy or is part of formulating policy.

Sonny Kuku, Ecobank, Nigeria

From the perspective of the parent board, the goal is not generally the devolution of strategic decision-making power. Parents are much more concerned about a potential misalignment between the strategy of the group and its implementation at lower levels of the organization. Parents want to ascertain that strategy is properly cascaded down into individual subsidiaries and implemented in practice.

This leaves open the question of the proper role of the subsidiary board in strategy. It is not realistic to think that a small subsidiary board is going to drive the strategy for a division or a parent, but neither should it rubber stamp everything that comes from the parent. There are many examples of subsidiary banks that mechanically take orders from parents, which ultimately proves detrimental to the subsidiary as well as the group. (See Box 4.1.)

Box 4.1: Subsidiary Input into Strategy

On the one hand, parents do not wish to cede control over strategy, products, and risk to local subsidiary boards. On the other hand, substantive input by local boards should protect local stakeholders and encourage a better understanding of local conditions and local risks. Local conditions do matter, and local boards cannot merely be rubber stamps or conduits for executing central command. The middle ground is a substantive interaction between the parent and the subsidiary that respects group strategy and ensures a full understanding of the local conditions.

Source: EBRD/IFC Southeast Europe Policy Brief 2012.

If it is not to actively develop strategy, the proper role of the subsidiary board is to provide essential input to ensure that the strategy that is developed at the higher levels of the group is sound and practicable. The subsidiary board's contribution is to provide feedback on the viability of strategy within the local context. The subsidiary board also has the responsibility to ensure that strategy is not implemented unthinkingly. Thus the subsidiary board's feedback on the effectiveness of strategy is essential.

D. Role of the subsidiary board in internal control and risk management

Earlier sections raised the issue of the control environment from the perspective of the parent. Risk management and control are complex issues, and to do them justice would require more detailed guidance than this publication can provide. The essential message here is that control and risk management depend crucially on local knowledge and involvement.

Parents typically conduct their risk-management, compliance, and internal audit functions centrally (IFC and EBRD 2012).³ Their subsequent goal is to ensure that organizationwide policy is properly implemented throughout the group. Yet risk analysis and control should not rely excessively on the work of the home office. To be most effective, they should be informed by local circumstances and draw on local expertise.

³ Some countries (for example, Poland) have an explicit ban on outsourcing risk-management and audit functions to the parent entity.

The subsidiary board can provide input that helps ensure that the strategy developed at higher levels is sound and practicable at the subsidiary level.

Risk analysis and control cannot rely solely on the home office.

Subsidiary boards should examine whether they are exercising sufficient oversight of the internal-control and risk-management functions or are relying excessively on services provided by the group.

Subsidiary boards can contribute to internal control and risk management through the following actions:

- Contextualizing information;
- Ensuring that central policy is adapted to the activities of the subsidiary; and
- Ensuring that ultimate responsibility and accountability for control and risk management resides locally.

A key question for subsidiary boards to ask themselves is whether they are exercising sufficient oversight of the control and risk-management functions or instead are relying excessively on services provided by the group. (See the illustration in Box 4.2.)

Box 4.2: Group-Level Oversight and Local Accountability

In the Bolivar Group, the boards of directors of the subsidiaries share a comprehensive vision of the group. Each company has defined and adapted its internal-control system and its risk-management system in accordance with its own activities, ensuring that the parent company's guidelines will be taken into account to define both systems. This means that each board is responsible for ensuring both the supervision of operation conducted by the relevant subsidiary and the proper management of individual risk, as well as being a source of monitoring and control on matters pertaining to the group.

Source: Adapted from materials by Bolivar Group.

Where this is not the case, subsidiary banks should consider developing their own risk analysis, and not rely exclusively on parent risk assessments. Where subsidiary banks and boards conduct their own risk assessments to evaluate local circumstances, these findings should be communicated to the parent bank.

Whether a bank subsidiary has a dedicated chief risk officer (CRO) depends on the size and nature of the operation. Subsidiary banks may have their risk-management function fulfilled by a CRO from the parent of the bank group, but the CRO should be capable of fully understanding the characteristics of the local environment (IFC and EBRD 2012). As with parent banks, subsidiary CROs should have direct access to subsidiary boards. Unfettered and unbiased communication channels are also important (IFC and EBRD 2012).

E. Director independence

Many see independent directors as a cure for all the woes of governance. Hard and soft laws increasingly demand the integrity, objectivity, and unbiased eye that independent directors are supposed to have. The expectations are high.

Independent directors are supposed to deliver objective reasoning and monitor areas of potential conflicts of interest. They are supposed to look over and rein in the potential excesses of management and safeguard minority shareholder interests. They are expected to staff committees that oversee areas that are vulnerable to conflicts of interest (audit, remuneration, and nominations). And they are expected to bring highly specialized skills and knowledge of local market conditions.

In some countries, independent directors are expected to ensure that management does not ride roughshod over the interests of stakeholders, such as depositors. In some post-transition economies, regulators may even expect independent directors to play a pseudo-regulatory role and monitor the bank, with the interests of the state at heart.⁴ Beyond that, independent directors are expected to have people skills and a sense of diplomacy to help them navigate sensitivities such as when the interests of a parent bank and a subsidiary conflict. Finally, analysts and governance-ratings agencies look at independent directors as indicators of good governance.

Living up to these expectations may appear to be an insurmountable challenge, in particular for the one or two independent directors typically nominated to a subsidiary board.

I have conflicting experiences with respect to the importance of independent directors in a bank subsidiary.

In some cases I found that the external independent director was a ceremonial burden, and that their value added was not very high. And I have experienced the opposite.

Patrick Zurstrassen, Independent Director,
Lombard Odier Funds (Europe) S.A., Former Chairman, ecoDa,
Member, IFC Private Sector Advisory Group

⁴ Such attitudes are likely a legacy of a centralized-planning era.

There are enormous expectations of independent directors.

Fulfilling such expectations is difficult and may, in fact, be unrealistic.

And there are problems with box-ticking approaches to selecting independent board members.

Part of the problem may also stem from how independent directors are selected. Often a checkbox approach is used. Checkbox approaches ignore the difference between independence in form and independence in fact, and they often ignore personal characteristics, such as the courage to challenge assumptions.

More and more it appears that the selection of independent directors does not focus sufficiently on the character of the individual. Nor does it focus sufficiently on what independence is supposed to deliver, namely objectivity, broad thinking, the capacity to take an ethical position, thoroughness, and a commitment to uncover the truth.

The real issue is the capacity of this person for independent thought and their ability to ask questions of management.

Milica Arnaudova-Stojanovska, National Bank, FYR Macedonia

More nuanced approaches to independence are emerging. Independence is no longer seen only as a set of hard and fast rules, but rather as a state of mind that describes not just individuals but also the board as a whole. For subsidiary boards, the focus need not be on formal independence, but rather on the capacity of all board members to think objectively and to challenge.

There is increasing acceptance of the notion that banks can be equally effective in achieving the goals of independent and objective thinking through the careful selection of board members from group executives from outside of the subsidiary or through non-executive directors who are not strictly independent. Nevertheless, in medium and larger markets, where there is supply of suitable candidates, and in larger subsidiary banks, independent directors should be considered as a potential additional safety mechanism and a source of needed challenge.

F. Board composition and director profiles

Board composition is the essential factor that determines the quality of board deliberations. The broad parameters of board composition are determined by local legal requirements, which may specify board size, a need for independence, fit and proper testing, board member nationality, and so on.

Thereafter, the composition of the subsidiary board is determined by the goals and expectations of the group. Two of the principal goals of the parent are to implement group strategy as well as to ensure effective controls and risk management. The composition of subsidiary boards in a closely integrated group thus tends to focus on ensuring compliance with group strategy and policies.

Parents are inclined to select directors who are operationally effective. Consequently, board members in closely integrated groups may have less of a role in developing strategy. Furthermore, it is unlikely that parents would select directors who would challenge central directives or who could potentially favor the subsidiary over the parent in the event that parent and subsidiary interests conflict. The potential drawback of a board composed of directors who are overly focused on effectuating the day-to-day business of the bank is that it may be too homogenous or may interpret its role as a governor too narrowly.

The best board has members with different views and different mentalities.

Walid Daouk, Non-Executive Director, Fransabank SAL, Lebanon

Some observers suggest that an absence of local citizens on a subsidiary board may limit the capacity of the board to properly assess the local environment, so it may be advisable to have local representatives on the board. On the other hand, a potential drawback of local board members is that they may lack experience or knowledge of the bank's operations. Thus legal requirements for local directors should be treated with some caution. A better solution may be to select directors who know the business of the subsidiary, including local customs and risks, irrespective of their national origin.

It is important to be aware that reporting relationships within a group influence board behavior. Frequently, directors and executives have reporting relationships to other directors, who

Boards of closely held subsidiaries seek a different director profile from boards of standalones.

Both parents and subsidiaries need to consider whether their current subsidiary board composition is best suited to address their needs.

are executives within the group structure. For some subsidiary directors, their performance evaluations and even their pay may depend on a colleague on the board. Subsidiary executives thus may be reticent to express their views too openly. This may support the argument for independent board members.

Both parents and subsidiary boards need to assess their circumstances and evaluate whether their subsidiary board composition is ideally suited to meet their needs, implement strategy, and manage their risks. The desired board member profile(s) can be set down in a nominations policy. Here are some of the parameters that can be considered:

- Expertise
- Skills
- Local experience
- Experience on other boards, including in other sectors
- Independence
- Contrasting perspectives
- Parent versus subsidiary director balance

Once selected, board members need to understand their roles and the expectations of the parent and subsidiary banks. Training can be useful for any group executive with the potential to become a subsidiary board member. Training should cover the particular challenges posed by subsidiary governance, including the obligations of board members to the subsidiary versus the parent and local stakeholders.

G. Subsidiary board committees

Committees are tools to help make decisions of critical importance. Board committees allow the board to devote time, attention, and technical expertise to issues of particular importance or issues of a technical nature. When committees are staffed with independent-minded directors, they can bring arm's-length decision making on issues where there is potential for conflict of interest. The most common committees in listed companies are the audit, remuneration, and nominations committees.

Whether board committees within subsidiaries generate value for the parent or the subsidiary is a matter of debate. Audit committees are a special case. They are frequently called for under host country law. Audit committees of closely held subsidiaries may even be required to have independent directors. Since both director nominations and executive remuneration tend to be decided at the parent level, remuneration and nominations committees are infrequent or play a diminished role. On the other hand, risk committees are increasingly considered essential for larger banks.

It is crucial to distinguish between compliance in form versus compliance with the spirit of the law. Most companies when establishing a foreign operation will comply scrupulously with the legal requirements to establish committees. However, the mere existence of an audit committee, for example, does not mean that it fulfills any of its expected functions or provides any of the assurances originally envisioned by lawmakers. Committees (like governance in general) founder on a compliance or box-ticking mentality and the absence of a corporate culture that is supportive of good governance.

Many emerging and post-transition economies have limited experience with committees and may greet them with skepticism or view them as bothersome legal hurdles. Indeed, ineffective or nonfunctioning board committees can be an indication that regulators have placed excessive confidence in the utility of mandatory committees as a governance tool.

But ultimately, the efficacy of committees depends on the bank. Weak committees can also be an indication that banks do not make full use of the tools at their disposal. Even if parents believe that all needed assurances are provided through other control and reporting mechanisms, they should examine the potential

Whether board committees within subsidiaries generate value for the parent or the subsidiary is a matter of debate.

Parents should examine the potential utility that a genuine audit committee—and some level of independent thinking—may have in better advancing their interests.

that committees (in particular a genuine audit committee with some level of independent thinking) may have in protecting and advancing their interests.

H. Board evaluations

Board evaluations serve to assess the function of the board and to determine how board practices might be improved. Formal board evaluations are increasingly common among listed companies but far less common in closely held companies or closely held subsidiary banks.

The UK Financial Reporting Council asks companies to make clear in their disclosures that they have gone through a board evaluation and that there are certain improvements that are undertaken at board level as a result of the board evaluation. But, no regulator in the UK or elsewhere asks for a copy of the board evaluation.

Stilpon Nestor, Nestor Advisors, United Kingdom

Some regulators are encouraging more board evaluations. The Financial Conduct Authority in the United Kingdom expects all U.K. incorporated companies to perform an annual board evaluation, regardless of whether they are subsidiaries. The Capital Requirements Directive IV in Europe also provides for an annual board evaluation for banks, which would include regulated bank subsidiaries.

Without doubt, the governance practices of subsidiary banks are a potential source of risk as well as a potential safeguard. As such, an examination of subsidiary governance practices could be a value-enhancing exercise.

When evaluating subsidiary board governance practices, it is important to consider not only the internal function of the board (the typical object of evaluation in standalone banks) but also the communication links, shared authorities, and degree of autonomy the subsidiary has with the parent.

Techniques for board evaluation can be divided into broad categories:

- Self-evaluations
- Assisted self-evaluations
- Independent third-party evaluations
- Supervisor evaluations

The main factors distinguishing the approaches are the degree to which the evaluation is under the control of the board and the extent to which outside parties may be privy to the results.

Boards typically want to limit the circulation of the results of evaluations. Self-evaluations intended for public disclosure have a strong tendency to be overly optimistic and are arguably of limited value. Submission of self-evaluations to supervisors usually make the evaluations guarded and the recommendations tepid. Consequently, self-evaluations are most likely to find support among boards and are most effective when used as internal tools.

Governance evaluations conducted by supervisors are not usually considered “board evaluations” as intended by Basel or other standards setters. Supervisors do not usually attend board meetings and cannot observe board dynamics. They rely on minutes, attendance records, fit and proper tests, and assertions of director independence. None of these is likely to help uncover substantive gaps in governance, nor will a supervisor evaluation directly lead into a remedial action plan tailored to the bank’s needs.

On the other hand, the requirement for subsidiary banks to conduct evaluations and at least disclose that such evaluations have taken place may force them to consider and strengthen their governance practices. As with other aspects of governance, banks will take evaluations seriously and extract value if the “tone at the top” is supportive. The involvement of a central corporate governance unit within a banking group may serve to define the governance practices that are required for subsidiaries throughout the group and to professionalize the evaluation process. (See Box 4.3.)

Evaluations intended for public disclosure or submission to supervisors have a strong tendency to be overly optimistic and are arguably of limited value.

The requirement to conduct evaluations may force subsidiary banks to consider and reform their governance practices.

A variety of techniques exist to conduct governance evaluations.

Box 4.3: Possible Steps for Subsidiary Governance Evaluations

- Use an external facilitator or expert, if necessary.
- Examine how the subsidiary board's governance supports the group strategy and how the subsidiary board interacts with the group.
- Conduct an evaluation against a benchmark to identify gaps:
 - evaluate formal board structures and policies;
 - evaluate effectiveness of existing processes and practices;
 - evaluate group dynamics and individual contributions; and
 - evaluate the skills required for the board to fulfill its duties.
- Consider any potential risks posed by the subsidiary's governance practices.
- Special considerations for subsidiaries:
 - consider how governance, monitoring, and control processes are shared with the parent;
 - consider the appropriate degree of autonomy of the subsidiary board, including potential need for independence; and
 - examine how the subsidiary board considers stakeholder issues.
- Develop an improvement plan.
- Implement the plan with an iterative process of review.

5. *Subsidiary Governance from the Perspective of the Supervisor*

Bank supervisors monitor the financial performance and operations of banks to ensure that they are operating safely and soundly and following rules and regulations. Bank supervision is conducted by governmental regulators and occurs to prevent bank failures. Recently, supervision has focused on curtailing high-risk lending and investing activities, which were at the core of the global financial crisis of 2007–2008.

One of the objectives of regulation is prudential, to reduce the level of risk that bank creditors are exposed to and, in particular, to protect depositors. Another is systemic risk reduction, to reduce the risk of disruption resulting from conditions that might cause major bank failures. To achieve these objectives, supervisors regulate and constrain banks. Regulations may reduce bank profits and efficiency in the name of more stable financial markets.

Banks share the same goals as supervisors; they benefit from stable financial institutions and markets. Yet their primary objective is to generate a return for shareholders. Banks do not aim at minimizing risk or reducing volatility per se. They make a living out of the assessment and management of risk, and they often perceive prudential regulation as hampering the conduct of business. These different perspectives make for different views on the role of governance in banks and bank subsidiaries.

From a regulatory point of view, boards and management should focus more on safety and soundness issues. But what governance structure is most conducive to achieving that end?

Mehran, Morrison, and Shapiro 2011

Regulators tend to want to see boards and management focus more on soundness issues. The first challenge for regulators is to identify governance practices that are effective in helping them achieve their stability goals. The second challenge is for them to identify governance practices that do not impose excessive constraints on business. In practice, this is far from simple. (See Box 5.1.)

Supervisors and banks have broadly congruent goals but may have different views on what governance practices work best for subsidiaries.

Box 5.1: The Chilling Effect of Poorly Conceived Regulation

A large global bank was in the midst of a significant acquisition of another financial services company that owned, as a very small part of its business, a bank in a jurisdiction where the acquirer had not previously operated.

One of the rules this small bank was subject to was that the appointment of a new CEO of the ultimate parent in the home country required the approval of the host country regulator.

The notion that the acquisition of a small bank as part of a large acquisition should result in wide-ranging powers being exercised over the whole group was clearly problematic and unacceptable to the acquirer.

It is difficult to identify optimal governance practices based on empirical testing.

Governance practices for bank subsidiaries need to be tailored to their specific circumstances.

Adding to the challenge is that the empirical evidence linking specific governance practices to risk is equivocal. In some cases the evidence is even contrary to what you might reasonably expect. For example, independent board members with financial experience may actually increase the risk profile of banks, according to Guerrero and Larsen (2008). And Minton, Taillard, and Williamson (2010) show a positive correlation between the experience of independent directors and volatility.⁵

Thus no one understands perfectly what works best. In the absence of hard empirical evidence, the tendency has been to emulate the governance practices of standalone and listed banks, under the assumption that they would work equally well for subsidiaries. Yet standalone governance practices are not likely to be well-suited for the variety of bank subsidiaries described in prior sections of this publication.

Ultimately, bank subsidiary governance practices can be expected to be effective only if they are adapted to the specific situation of subsidiary banks. Unfortunately, the existing know-how on what governance practices work best in subsidiary banks is quite limited. More work needs to be done to research and document good practice.

⁵ Mehran also shows that experience requirements may not have their intended effect, citing the examples of Northern Rock's board (which included a former bank CEO, a top fund manager, and a previous member of the Bank of England's governing body) and Bear Stearns (where 7 of 13 members of the board had banking backgrounds).

A. Proportionality

Company law sets the foundations on which all companies operate. Banks in a host country are typically subject to minimum requirements under company law, and they also must comply with banking regulation. Mandatory governance requirements for all banks generally include the following:

- Responsibilities of the board
- Basic parameters of board size and composition
- Qualifications of directors
- Fit and proper testing

Such minimum standards establish an even playing field for all and set down a minimum level of governance that all banks must comply with. Thereafter, supervisors may apply a risk-based approach to governance, with requirements that are proportionate to the nature, scale, and complexity of the subsidiary's business and risks.

All systemically important financial institutions (SIFIs) are likely to be subject to more stringent governance requirements and oversight. Requirements for SIFIs could include some of the measures more commonly applied to standalone banks:

- Separation of board chair from chief executive positions
- Minimum number of independent board members
- Mandatory audit committees and possibly other committees
- Independent directors on audit committees
- Local board members
- Expanded disclosure on corporate governance

In some countries, subsidiaries of foreign banks are SIFIs. It can also occur that all of the SIFIs in a country are foreign owned. Though the subsidiary may not be a significant operation from the perspective of the parent, the fact that it is of systemic importance within the host country merits special approaches to governance.

Supervisors should apply a risk-based approach to governance, with requirements that are proportionate to the nature, scale, and complexity of the subsidiary's business and risks.

Whether specific governance practices should be fixed in law or voluntary depends on whether the subsidiary bank is systemically important and also on local business culture.

B. Mandatory versus voluntary approaches

A key question is the degree to which subsidiary governance requirements should be voluntary or mandatory. Basic governance requirements need to be embedded in law. However, the enormous diversity in subsidiary structures suggests a more tailored or principles-based approach. As noted above, whether a subsidiary is an SIFI or not is the key consideration.

In most of our countries corporate governance for banks is mandatory. In our markets even where comply or explain exists, it is not practiced.

Kiril Nejkov, IFC, FYR Macedonia

The choice is also contextually dependent. Not all countries have experienced supervisors with the capacity for the sophisticated judgment required under voluntary systems. Civil law countries and post-transition economies have traditions of prescriptive regulation. In these countries, voluntary or principles-based approaches (for example, “comply or explain” and voluntary codes of corporate governance) tend to enjoy less acceptance and success. Approaches that are effective in developed markets with mature regulatory structures may not be effective in countries where the rule of law is weak and strong regulation may be the only means to the end.

A proper balance needs to be struck between mandatory and voluntary or principles-based approaches. For corporate governance of subsidiaries, this will require regulators to have a profound understanding of the complexities faced by global banks operating in multiple jurisdictions under different business models and with different governance approaches.

We should not talk about adding burdensome extra rules. I think we've got enough regulation and I would say the less is better. What is needed today in the overregulated environment is reasonable, thoughtful, systematic and proportionate enforcement of a modest set of rules by competent supervisors understanding risks, business models, and the idea that banks need to earn money as any other business, even if this business has vast public good implications.

Piotr Bednarski, PricewaterhouseCoopers, Poland

Finally, regulation should aim to be as effective as possible without causing undue burdens. “Light touch” is clearly out of favor in the wake of the 2007–2008 financial crisis. Nevertheless, the goal should be effective regulation that reins in excessive risk taking while allowing businesses sufficient flexibility to innovate and pursue efficiency.

C. Dialogue between supervisors and banks

Supervisors are more effective in achieving their goals when they are able to engage with banks and communicate their expectations. Host country supervisors also benefit from dialogue with foreign parents to help them develop a better understanding of group strategy. Strong relationships and open dialogue with banks also help supervisors develop better rules.

An effective supervisory process includes open dialogue between a bank and its regulator as well as dialogue between home and host country regulators. This allows banks to refine their governance practices to meet regulatory expectations and helps regulators to understand the practical challenges that can be presented when banks are faced with inflexible rules.

Antonella Deo, Manulife, Canada

Models exist for successful collaboration between supervisors and bankers. A number of countries have traditions of direct public consultation and/or the constitution of expert committees to advise the government.

There are different views on the potential for dialogue between supervisors and banks. One prerequisite may be supervisors with sufficient training, experience, and skills. Another may be banks that are willing to commit time and effort to contribute to the development of a sound regulatory framework. Such collaborative approaches appear to be more prevalent in common law countries.

Where such discussion is not part of the rule-making tradition, the default is toward a rules-based and directive approach. This being said, anecdotal evidence suggests that even in post-transition countries with strong directive traditions, practice is changing in favor of greater consultation with business and other stakeholders. Broad consultation is increasingly viewed

Dialogue between supervisors and banks helps communicate supervisor expectations and helps supervisors craft more effective rules and avoid the unintended consequences of poorly designed regulation.

as an irreplaceable tool for developing high-quality adapted regulation and for preparing business and society for new rules.

D. Dialogue between home and host country supervisors

International cooperation between supervisors is important, because it is not possible to regulate global capital locally in a global economy. Links between banks are increasingly intertwined, and capital and risk can move almost instantaneously, often propagated by complex financial instruments (IFC and EBRD 2012). As a consequence, supervisors are expected to be in contact, cooperate, and share information with their counterparts in other jurisdictions.

Coordination among superintendents, regulators and supervisors is key. There is a problem with the asymmetry of regulatory standards.

Felipe Rincon, Grupo Bancolombia, Colombia

Dialogue and cooperation between home and host country supervisors serve to accomplish the following:

- Facilitate the oversight of banks that operate in multiple jurisdictions;
- Better assess and control for the potential for international contagion;
- Enhance understanding of international best practice in governance and supervision; and
- Better understand the regulations and supervisory approaches of other countries and their potential impact on the host supervisor.

The tools used for such cooperation are usually memoranda of understanding and periodic meetings among supervisors through regulatory colleges (IFC and EBRD 2012).

There are contrasting views on the effectiveness of cooperation between home and host country supervisors; it is alternatively seen as sufficient or as needing significant enhancement. Perceptions appear to be less positive among small host countries that felt vulnerable during the recent crisis. In Southeast Europe, for example, there was widespread disappointment

with memoranda of understanding that were perceived to be of limited use and insufficient to ensure that relevant information was shared on a timely basis (IFC and EBRD 2012). There are also concerns that regulatory colleges may not be sufficiently attuned to the interests of smaller members.

A potential disincentive to international cooperation may come from the different interests and duties of home and host country regulators. Regulators operate primarily in the interests of the citizens of their own country; to do otherwise would imply a breach of their duty. So it is likely that if an issue is identified by a home country supervisor within that supervisor's jurisdiction, there may be disagreement with the host country supervisor.

A home country supervisor may be reluctant to support a parent or be concerned regarding a potential downstream impact if the parent is not systemically important at home. Situations that hold the greatest potential for divergence of interests are those where a subsidiary bank is systemically important in the host country while the parent is not material in the home country. (See Figure 5.1.)

The interests of home and host country supervisors may conflict, since supervisors operate first and foremost in the interests of their own citizens.

Home and host regulator interests can diverge particularly when the host country subsidiary is systemic but non-material from a group perspective.

Figure 5.1: Convergent and Divergent Interests of Home and Host Country Regulators

Home Country	Host Country	Comments
Non-material subsidiary from group perspective	Non-systemic Bank	Both Home and Host share similar perspective — no material risk for Home and Host country
Material subsidiary from group perspective and parent group systemic in Home country	Systemic Bank	Both Home and Host might share similar view on the risk of the group to Home and Host banking systems; likely their interest are aligned
Material subsidiary from group perspective but the group is non-systemic in Home country	Systemic Bank	Interest and perceptions of Home and Host possibly divergent; Home less concerned as the parent group is not systemic while Host supervisor likely concerned due to systemic impact of the subsidiary
Non-material subsidiary from group perspective	Systemic Bank	Likely different perspective of Home and Host supervisors; potential divergent interests; Home supervisor might underestimate challenge for Host; the most common situation in many regions like CEE and SEE
Material subsidiary from group perspective and systemic group in a Home country	Non-systemic Bank	Interest and perceptions of Home and Host possibly divergent; Home more concerned when the group is systemic in Home country; rare situation though there might be cases in major financial centers like London

Source: PricewaterhouseCoopers.

Interests tend to be aligned when neither the parent nor the subsidiary are materially important to the local market. However, when tough decisions need to be made, it appears likely that the stability of the local market will take precedence over the stability of the foreign market.

E. Dialogue between host country regulatory institutions

A third dimension of dialogue is communication between different regulatory institutions within a country. In some countries, banks are subject to a single banking regulator, and in others they may be accountable to multiple supervisory institutions. Information sharing and coordination between different institutions is likely to enhance supervisory efforts.

In the contrary case, divergent policies may be promulgated by different bodies. This is most likely to occur when banks are listed on securities exchanges and subject to securities-markets regulation in addition to that of banking supervisors. Multiple reporting rules at home and in foreign jurisdictions are also burdensome.

“This kind of patchwork of supervision is not really healthy. This is a recommendation for supervisors; co-ordinate as much as possible both internally and cross border.”

Piotr Bednarski, PricewaterhouseCoopers, Poland

The need for better coordination and information sharing is not limited to less-developed banking markets. In the United States, one of the suggestions for avoiding failures similar to that of Lehman Brothers has been to enhance collaboration between the Securities and Exchange Commission and the Federal Reserve. Inquiries in the United Kingdom into the banking crisis also pointed to a need for better communication between regulatory bodies.

Better in-country dialogue, information sharing, and cooperation between institutions is also expected to enhance supervisor effectiveness.

6. *Appendixes: Existing Guidance on Bank Subsidiary Governance*

Appendix A: Selected portions of the Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance

Appendix B: Selected portions of the IFC/EBRD Policy Brief on Corporate Governance for Banks in Southeast Europe

Appendix A: Selected portions of the Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance

Principle 4

In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

Board of parent company

61. In the discharge of its corporate governance responsibilities, the board of the parent company should be aware of the material risks and issues that might affect both the bank as a whole and its subsidiaries. It should therefore exercise adequate oversight over subsidiaries, while respecting the independent legal and governance responsibilities that might apply to regulated subsidiary boards.
62. In order to fulfil its corporate governance responsibilities, the board of the parent company should:
 - establish a governance structure which contributes to the effective oversight of subsidiaries and which takes into account the nature, scale and complexity of the different risks to which the group and its subsidiaries are exposed;
 - assess the governance structure periodically to ensure that it remains appropriate in light of growth, increased complexity, geographic expansion, etc;
 - approve a corporate governance policy at the group level for its subsidiaries, which includes the commitment to meet all applicable governance requirements;
 - ensure that enough resources are available for each subsidiary to meet both group standards and local governance standards;
 - understand the roles and relationships of subsidiaries to one another and to the parent company; and
 - have appropriate means to monitor that each subsidiary complies with all applicable governance requirements.

Board of regulated subsidiary

63. In general, the board of a regulated banking subsidiary should adhere to the corporate values and governance principles espoused by its parent company. In doing so the board should take into account the nature of the business of the subsidiary and the legal requirements that are applicable.
64. The board of a regulated banking subsidiary should retain and set its own corporate governance responsibilities, and should evaluate any group-level decisions or practices to ensure that they do not put the regulated subsidiary in breach of applicable legal or regulatory provisions or prudential rules.

The board of the regulated banking subsidiary should also ensure that such decisions or practices are not detrimental to:

- the sound and prudent management of the subsidiary;
- the financial health of the subsidiary; or
- the legal interests of the subsidiary's stakeholders.

Appendix B: Selected portions of the IFC/EBRD Policy Brief on Corporate Governance for Banks in Southeast Europe

Recommendations addressed to bank subsidiaries

Stature of subsidiary boards: Some boards of local banks that are important for the local economy are staffed by middle-level management of the international group. These board members do not necessarily have the banking experience that a significant institution in the local economy requires. Board members need to have the stature and experience commensurate with the importance of the subsidiary in the local economy. Local expertise is useful on subsidiary boards.

Independence on boards of subsidiaries: It is not desirable to prevent owners of wholly owned foreign subsidiaries from determining the specific composition of their supervisory boards, though some level of independence on the boards of foreign subsidiaries is considered to be beneficial. The committees of subsidiary boards, in particular the audit committee, could benefit from the presence of independent board members. Consideration should be given to mandating a minimum level of independent board members for subsidiary boards. This may be particularly important if the foreign subsidiary is among the top banks within the country.

Boards of subsidiaries: The legal framework should ensure that the boards of subsidiaries that are systemically important to the local banking system localize certain key strategic and control responsibilities without impairing the significant benefits of group wide consolidation of key controls and business practices.

Such localization is intended to improve decision making, enhance internal control, and provide better assurances to local stakeholders. This means, among other things, that certain subsidiaries may be required to have independent board members as well as audit committees staffed by independent board members. Such independent board members should, in principle, be able to police conflicts of interest between parents and local stakeholders. Expectations regarding the capacity of independent board members to be proactive and to police conflicts of interest should be realistic. In practice, independent board members of local boards are constrained by parent/subsidiary rules and may be limited to signaling that conflicts of interest exist.

Coherence between localization of board and control functions: Where there is to be greater responsibility of subsidiary boards, then the role of other functions, such as internal control, internal audit, and compliance, will need to be structured in a way that makes them consistent with the strengthened role of the local board.

New products at subsidiary level: There should be more formalized review of new products. For major foreign bank subsidiaries, the board still needs to be apprised of major product changes or relocations (such as the shifting of a product to another local subsidiary or affiliate) and the impact of such changes. Also, foreign subsidiary boards should be apprised of product evolution and introduction to the locale, if they are to be responsible for local operations. The head office should not simply push product down without a proper vetting at the locale.

Local boards may not necessarily be able to approve products, but rather they should review products that have been launched and risks that have been generated.

Recommendations addressed to parent banks

Group structures: Parent banks need to be aware of subsidiary bank governance practices and ensure that subsidiary banks adhere to appropriate governance practices from both parent and subsidiary jurisdictions. They should ensure that the subsidiary respects local legal requirements and acts with due concern for local stakeholder interests. Subsidiaries of foreign banks in SEE must adhere to the governance practices of parent banks while adhering to local legal requirements.

Boards of parent banks: The board of the parent bank should approve a corporate governance policy at the group level for its subsidiaries. The policy should clearly map out the relationship between group and subsidiary boards as well as the relationship between group and subsidiary functions and businesses. The board of the parent bank should periodically assess the governance structure and ensure that enough resources are available for each subsidiary to meet both group and local governance standards.

Recommendations for supervisors

Meetings with bank boards: Supervisors should meet regularly with boards and chief risk officers, or equivalent, during visits and inspections. This includes subsidiary boards. Supervisors should require the full board to meet locally at least once a year. The supervisor should meet annually with the board to discuss current issues, even when the bank is in satisfactory condition. These meetings should be conducted locally.

Understanding home-subsidiary relations: To varying extents, supervisors place confidence in the ability of head offices to oversee their local subsidiaries. This trust should not turn into blind confidence. Supervisors need to develop the capacity to look through to the parent's control systems. Supervisors should be aware of and understand the scope of reporting and oversight provided by head offices, in part by reviewing the nature and configuration of key reports. If obvious gaps exist, it may require dialogue between the supervisor, the parent and the subsidiary and understanding of the issue or risk by all parties.

Incentives and behavioral issues: Companies and regulators are encouraged to look at behaviors and culture ahead of structure and processes. Boxes and checklists may have value but they are insufficient. More attention needs to be paid to the variety of stakeholders in the governance process and the incentives that contribute to good governance. A multipronged, long-term approach involving a wider range of players in the governance equation may serve to create the desired cultural change. To start, a more active dialogue is needed between banks and supervisors.

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