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Emerging Best Governance Practices in Commercial Financial Institutions:

An Overview of Best Practice in Corporate Governance

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Introduction

As a basis for roundtable discussion, this short paper provides an overview of best practice in corporate governance in major financial institutions in Australia.

The checklist of best practices is drawn largely from the governance practices of the four major banking groups in Australia (viz ANZ Banking Group Ltd, Commonwealth Bank of Australia, National Australia Bank Ltd, and Westpac Banking Corporation). Each of these banking groups is committed to embracing best practices in governance and to monitoring developments in corporate governance internationally.

From a structural perspective, the governance framework of the banking groups can be summarized as follows:

- Board of directors (including board committees)
- CEO
- Heads of business units (direct reports to CEO)
- Chief financial officer (direct report to CEO)
- Heads of central risk management, compliance and audit functions (usually reporting to the chief finance officer or direct to the CEO ie; they are independent of the business units)

While the addition of a supervisory board in Chinese institutions requires some adaptation of governance structures across countries, the practices outlined in this paper remain highly relevant and applicable (particularly in terms of their intended objectives).

The paper concentrates on practices at the board level on the grounds that the board of directors is the focal point of corporate governance in a commercial enterprise.

Governance practices can be grouped according to their relationship to structural, process or people issues.

Structure

The more important structural issues are tabulated below.

1) Board chairman

In each of the four banking groups the chairman is an independent non-executive director (ie; there is separation of the roles of the group chairman and the chief executive officer)

2) Board size

Modern thinking is towards more compact boards in the interests of efficiency in decision-making and debate. The size of the boards of the major banking groups ranges from 8 to 13 directors.

3) Majority non-executive directors

Non-executive directors comprise the majority of the board in every case. In fact in three of the four banking groups there is only one executive director (the CEO).

4) Majority independent directors

All of the non-executive directors in each banking group meet formal tests of independence (notably those specified by the Australian Stock Exchange and the particular bank's own independence criteria).

Without going into detail, to qualify as "independent" a director must be a non-executive who is free of any business or other association – including those arising out of a substantial shareholding, involvement in past management, acting as a current or past advisor, consultant or auditor, or being a customer or supplier – that could impair the exercise of independent judgement.

5) Tenure

Limits on the time directors may serve vary across the four banking groups but a common pattern involves appointment (subject to election by shareholders at the next AGM) for a term of three years, with a limit (subject to re-election) of three or four terms ie; a tenure limit of 9 to 12 years.

6) Board committees

Each of the banking groups has the following board committees:

- Audit
- Nominations (alternative titles being "governance" and "board performance and renewal")
- Remuneration (alternative titles being "people" and "people and remuneration")
- Risk

In addition to these four core committees, one banking group has a “technology committee” while another has a “corporate responsibility and sustainability committee”.

7) Committee composition

All committees comprise a majority of independent directors.

Only the nominations committee is chaired by the board chairman. The other committees are chaired by independent directors other than the board chairman.

Membership by the board chairman in other committees varies between banking groups – at the extremes, in one case the chairman is not a member of any other committee while in another the board chairman is an ex-officio member of all committees.

CEO participation in board committees is strictly limited. In three of the four banking groups the CEO is not a member of any of the four core committees (in the banking group that is the exception, the only committee that includes the CEO is the risk committee).

A primary objective of the committee process is that deliberations and decision-making should be free of undue influence by the board chairman or the CEO.

8) Access to management

In the case of the audit and risk committees, there must be provision for the committee to meet as regularly as it deems appropriate (and at least annually) with the head of internal audit and the chief risk officer respectively in the absence of other management. The purpose of these private meetings is to enable the committee to be satisfied as to the independence of the function and the objectivity of views and information provided to the committee.

Apart from these formal arrangements, directors have complete and open access to management, subject to keeping the CEO informed to ensure that there is no confusion as to reporting lines and accountability.

Process

A brief overview of selected process issues is provided below.

1) Charters

In each of the four banking groups, the functions and responsibilities of the board are clearly defined in the board charter.

Similarly, each board committee has a charter, approved by the full board, that defines the committee’s role, objectives and powers.

2) Delegated authorities

Each of the banking groups has a comprehensive written delegations policy that specifies matters preserved for decision by the board or its committees, those delegated to the CEO, and those delegated through the CEO to other levels within the organization.

The entire delegated authorities document is typically reviewed annually.

Accountabilities are linked to these authorities.

3) Meeting frequency

The board meeting schedule typically provides for about 10 meetings per year, with provision for additional meetings to deal with urgent or complex matters as deemed necessary.

At least one board meeting per year is devoted entirely to strategy development and normally extends over two days at an offsite location.

Board committee meetings occur at least quarterly – and generally more frequently for the audit and risk committees.

4) Meeting agenda and proceedings

Care is taken in designing the board meeting agenda to ensure that priority is given to strategic matters (both strategy design and strategy execution), overall financial performance and sustainability.

The chairman, with input from the CEO, designs the core components of the meeting agenda over a 12 month time horizon to ensure that there is balanced coverage of financial, strategic and major risk areas throughout the year.

Without careful management, board meetings and board papers can become overly immersed in short-term operating and performance issues, to the exclusion of the board's core responsibilities.

In conducting the board meeting the chairman also needs to have close regard for the three distinct functions the board performs:

- It decides (those things preserved for decision by the board)
- It monitors (the performance and financial standing of the business)
- It advises (by acting as a sounding board for senior management and a source of council and advice based on the experience and wisdom of the directors)

5) Ethics

In addition to the legal obligations of directors, each banking group has comprehensive codes of conduct (or statements of professional practice) that set out the ethical standards to which directors are expected to adhere (practice varies as to whether there is a code specifically for directors or whether there is a single code that applies equally to directors,

senior executives and all employees).

6) Conflicts of interest

With a board comprised of high calibre directors, the other activities and business connections of directors will inevitably raise conflicts of interest from time to time.

In addition to directors' obligations under the corporations law, each banking group's governance practices specify that when a potential conflict of interest arises, the director concerned must declare that conflicted position. On such declaration, the director concerned:

- Does not receive relevant board papers
- May not be present during board deliberations on the matter
- Is precluded from exercising any influence over other directors on the matter concerned
- May not vote, or be present during a vote, on any related board resolutions

7) Securities trading

In addition to insider trading prohibitions under corporations laws (both in Australia and overseas jurisdictions) each banking group has prescriptive restrictions on trading by directors (and employees) in the shares of the company.

The specifics of these restrictions vary, but it is common for dealing to be restricted to specified "windows" during the year and, even when dealing is permitted, directors are precluded from engaging in trading of a short-term nature.

8) Director education

Common practice involves-

- A directors' handbook containing a broad range of information on matters relevant to the role
- A formal induction program
- Provision for continuing education, involving information sessions and workshops (conducted by internal and external experts) and site visits (both within the business and to other entities, both within Australia and overseas, which may be repositories of knowledge and experience of particular relevance to the business).

9) Advice

The board collectively, and each director individually, has the right to seek independent professional advice, at the company's expense, to help them to discharge their responsibilities.

In the case of directors acting individually, the chairman's approval is needed before seeking advice, but this may not be unreasonably withheld.

Where an individual director obtains such advice it should be made available to all directors.

10) Performance evaluation

A major development over recent years has been an intensified and formal process of assessing and reviewing the performance of the board collectively, of board committees and of each director individually.

Evaluation practices include:

- A defined process for annually reviewing the board's performance, policies and practices
- Completion of written surveys/questionnaires by directors and senior executives
- One-on-one meetings by the chairman with individual directors
- Engagement of an external expert/consultant to facilitate the board evaluation process every second year
- Assessment of the quality and effectiveness of board papers and other information made available to directors
- A separate review of the effectiveness of the board chairman (commonly undertaken by the nominations committee in the absence of the board chairman)
- Allocation of time at the end of each board meeting for non-executive directors to meet in the absence of the CEO and other executives
- One bank employs the practice of appointing a director at each meeting, on a revolving basis, to critique the meeting and report his/her findings at the conclusion of the meeting.

People

1) Primacy of people

The people dimension is of critical importance.

Good governance occurs through good behaviours, leading to good outcomes.

Well designed structures and efficient processes do not guarantee good behaviours.

Selecting the right people to serve as directors is therefore of paramount importance.

2) Fit and proper

Each of the banking groups has a comprehensive and robust framework to ensure that individuals considered for board or senior executive appointments have the fitness and propriety to discharge their prudential responsibilities.

These internal requirements can readily be dovetailed with the fit and proper compliance standards set by the prudential regulator (APRA in the case of Australia).

3) Selection criteria

The banking groups have their own specific criteria (undisclosed) for director selection but generic requirements embrace propriety, skills, qualifications, experience, communication capabilities and community standing.

A useful framework that can be applied to the essential qualities of directors involves the six “i’s”:

- *Integrity*
- *Intellectual capacity*
- *Independent thinking* (involving an instinct to get to the heart of complex issues and an ability to exercise independent judgement without being unduly influenced by the views of management or other parties)
- *Interpersonal skills* (must be able to work within the board as a collegiate process)
- *Interest* (must be genuinely interested in the company and the financial services industry, supported by relevant experience and expertise)
- *Intent* (must have the capacity and commitment to devote the time required to discharge the responsibilities of a director)

4) Mix

Commensurate with the tendency for boards to be of smaller size, increased attention is given to finding the right combination of skills and experience among the directors when considered collectively.

Each banking group strives to create a board of directors with the optimum balance of skills, knowledge, and diversity of experience and perspective across the ranks of the directors.

5) Renewal

A critical role of the nominations committee is to undertake succession planning, both for the role of chairman and by having a selection of potential candidates to replace each director in the event that this may be required.

In addition to replacement planning, careful regard is paid to the desirability of new director appointments to ensure that the board receives the benefit of new thinking and recent or different experiences. While a core of experienced directors is sought, the injection of new ideas and expertise is also desirable, particularly given the change dynamics in the financial services industry.

Notably, one banking group has renamed its nominations committee as the “board performance and renewal committee” as a clear signal of the importance placed on the renewal dimension.

Conclusion

The points outlined above are not intended to be definitive but are provided as an aid to discussion.

Further information about the practices of the four major Australian banking groups can be obtained from the comprehensive corporate governance statements that are available on their respective websites.