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# **Corporate Governance**

Prudential Supervision Department  
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## **A. Introduction**

### ***A.1 Corporate governance and the Reserve Bank's objectives***

1. This document sets out the Reserve Bank of New Zealand's (Reserve Bank's) policy on registered banks' arrangements for corporate governance.
2. The Reserve Bank has powers under Part 5 of the Reserve Bank of New Zealand Act 1989 (the Act) to register banks and undertake prudential supervision of registered banks.
3. Section 68 of the Act requires the powers under Part 5 of the Act to be exercised for the purposes of:
  - a. promoting the maintenance of a sound and efficient financial system; or
  - b. avoiding significant damage to the financial system that could result from the failure of a registered bank.
4. Section 68A of the Act requires that the Reserve Bank, when exercising its part 5 powers, must support Australian authorities in pursuit of Australian financial stability and where reasonably practicable avoid actions that might be detrimental to Australian financial stability.
5. The objective of this Corporate Governance policy is to strengthen the underpinnings of financial stability, by imposing minimum standards and issuing guidance in those areas of corporate governance practice which are most directly relevant to the stability of the New Zealand financial system.
6. In its implementation of banking supervision in pursuit of its Section 68 objectives, the Reserve Bank has adopted an approach based on "three pillars": regulatory discipline, market discipline and self-discipline. Under the self-discipline pillar, the Reserve Bank aims to ensure that the shareholders, board of directors and senior executives of a registered bank are subject to the strongest incentives possible to run the bank prudently in the interests of financial stability. Influencing corporate governance outcomes is one of the Reserve Bank's main tools to achieve this.
7. The general principles of good corporate governance stem from attempts to resolve the principal/agent problems that can arise between shareholders of a company, and senior management responsible for its day-to-day operations. They do so broadly by ensuring that the interests of the shareholders are properly represented, via the board of directors, in such areas as risk management, the setting of corporate strategy, and ensuring that strategy is followed through.
8. Corporate governance practices in banks need also to take account of wider financial stability considerations. Bank shareholders would normally be concerned about the long-term preservation of a bank's value, and the promotion of their interests therefore aligns to some extent with standard financial stability objectives. However, particularly in cases where a registered bank is a wholly-owned subsidiary, conflicts can arise between the interests of the parent entity and the financial stability objectives of the Reserve Bank.

9. Reflecting this concern, the Reserve Bank states in its principles for determining applications to be registered as a bank<sup>1</sup> that it needs to be satisfied that there will be sufficient separation between the bank and its owners. Some of the requirements and guidance in this policy are directed specifically at promoting an appropriate degree of separation of this sort, both on initial registration and on a continuing basis. Otherwise they support the general objectives of good corporate governance.
10. This policy does not aim to be a comprehensive statement of good corporate governance practice. Comprehensive guidance is available elsewhere, and in particular there are two documents that are relevant for New Zealand-incorporated banks:
  - a. “Corporate Governance in New Zealand Principles and Guidelines: A Handbook for Directors, Executives and Advisers”, published by the New Zealand Securities Commission in March 2004. These Principles are intended to be applied to the governance of entities that have economic impact in New Zealand or are accountable, in various ways, to the public.
  - b. [“Principles for enhancing corporate governance”] published by the Basel Committee on Banking Supervision in [XXX 2010]. The guidance in this document is intended to assist banking organisations in enhancing their corporate governance frameworks.
11. This policy does not apply to New Zealand branches of overseas-incorporated banks. It is not meaningful to attempt to impose a degree of separation between the branch and the global bank of which it is legally a part, and the corporate governance arrangements of the global bank are outside the remit of the Reserve Bank. However, branches are subject to certain disclosure requirements relevant to corporate governance, under the Reserve Bank’s bank disclosure regime. These are summarised in the section on public disclosure below.

## **A.2 *Conditions of registration***

12. Section 74 of the Act permits the Reserve Bank to impose conditions of registration that relate to, among other things, the matters referred to in the following sections of the Act:
  - a. 73(2)(a) and 73(2)(e); and
  - b. 78(1)(e), 78(1)(f) and 78(1)(fa);
13. Those sections address, among other things, matters that can include: the incorporation and ownership structure of the bank; the suitability for their positions of the directors and senior managers of the bank; separation of the business carried on by the bank from other business and from other interests of any person owning or controlling the registered bank; the bank’s internal controls and accounting systems; and the bank’s risk management systems.

## **A.3 *Guidelines***

14. Under Section 78(3) of the Act, the Reserve Bank may issue guidelines for the purpose of interpreting whether a bank is carrying on business in a prudent manner with regard

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<sup>1</sup> *Statement of Principles: Bank Registration and Supervision*, Banking Supervision Handbook document BS1

to the matters identified in Section 78(1) of the Act. The matters in 78(1) that are of interest here are:

(e) separation of the business of the bank from other business and from other interests of any person owning or controlling the registered bank;

(f) internal controls and accounting systems or proposed internal controls and accounting systems; and

(fa) risk management systems and policies or proposed risk management systems and policies.

#### **A.4 Disclosure to the public**

15. Under section 81 of the Act, the Governor General may, on the advice of the Minister and in accordance with a recommendation by the Reserve Bank, prescribe information or data that registered banks must publish in disclosure statements.

### **B Conditions of registration**

16. Under the Reserve Bank's Corporate Governance policy, a New Zealand-incorporated registered bank is normally subject to the conditions of registration set out in Appendix 1.

#### **B.1 Board size and composition**

17. The standard requirements are that the board of the bank has at least five members, that the majority of those members are independent (with any alternates also independent), and that the majority of the independent directors on the board are ordinarily resident in New Zealand. Thus, for instance, a board with 8 members must have at least 5 independent directors, and at least three of those must be New Zealand resident. One of the independent directors can be the chair.
18. For the purposes of this policy, a director of a registered bank is *independent* except in the case that the director:
- a. controls or has significant influence over the registered bank, or is an officer of an entity that controls or has significant influence over the registered bank, or met either of the foregoing conditions at any point during the three years immediately before their current appointment to the board;
  - b. is employed, or has previously been employed, in an executive capacity by the registered bank or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board;
  - c. is a director or has previously been a director of a group member, other than the registered bank or a subsidiary of the registered bank, and there has not been a period of at least three years between ceasing such directorship and serving on the board;
  - d. has within the last three years been a principal of a material professional adviser or a material consultant to the registered bank or another group member, or an employee materially associated with the service provided;

- e. is a material supplier or customer of the registered bank or other group member, or is an officer of a material supplier or customer; or
- f. has a material contractual relationship with the registered bank or another group member, other than as a director of the registered bank.

19. Where –

- a. “control” has the meaning in section 5 of the Companies Act 1993;
- b. “group” means the group of companies comprising all subsidiaries of the registered bank, all holding companies of the registered bank, and all subsidiaries of holding companies of the registered bank;
- c. “officer” of an entity means a director of the entity or a person:
  - i. who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the entity; or
  - ii. who has the capacity to affect significantly the entity’s financial standing; or
  - iii. in accordance with whose instructions or wishes the directors of the entity are accustomed to act (excluding advice given by the person in the proper performance of functions attaching to the person’s professional capacity or their business relationship with the directors or the entity).
- d. “significant influence “ has the meaning in section 2(1) of the Act.

20. This definition of an independent director is intended to ensure that the director is free from any business or other association that could materially interfere with the exercise of their independent judgement.

**B.2 Board chair**

21. The chair plays an important leadership role on the board, promoting co-operation, mediating between different perspectives, and leading informed debate and decision-making. The chair also acts as the main link between the CEO and the board. For these reasons, the standard conditions of registration require the chair of a registered bank to be independent.
22. However, this is one requirement on which the Reserve Bank may consider varying the standard condition of registration, provided that the objectives which are intended to be achieved by having an independent chair are still broadly met. (See under “*Variations to standard conditions of registration*” below.)

**B.3 Acting in best interests of the bank**

23. The aim of the conditions discussed above is to ensure as far as possible that the board collectively will, in practice, take decisions in the best interests of the bank, without undue influence from parties whose interests may diverge from the bank’s. There is also a condition which prohibits the registered bank from having in its constitution a

provision permitting a director, when exercising power or performing duties as a director, to act other than in what he or she believes is the best interests of the bank.

24. Although a director of a company, when exercising powers or performing duties as a director, is normally required under the Companies Act 1993 to act in good faith and in what the director believes to be the best interests of the company, section 131(2) of the Companies Act allows a director of a subsidiary to act in a manner which he or she believes is in the best interests of its holding company even though it may not be in the best interests of the subsidiary, if expressly permitted by the subsidiary's constitution. Therefore this condition of registration prohibits the registered bank's constitution from placing a legal constraint of this sort on a director acting in the bank's best interests.

#### ***B.4 Board audit committee***

25. Among the board's key responsibilities is to ensure the integrity of the bank's financial controls, reporting systems and internal audit standards. Having a separate, suitably constituted audit committee ensures that greater focus and expertise is brought to bear on these matters, and also enhances the objectivity of the board's oversight of this important area. While the Reserve Bank would normally expect a registered bank to have board committees covering other areas also, because of the particular importance it attaches to audit committees there is a separate condition of registration specifically requiring the bank to have an audit committee, with sub-conditions designed to ensure its independence.

#### ***B.5 Variations to standard conditions of registration***

26. The Reserve Bank is prepared to consider variations to the standard conditions of registration. This may be possible where a registered bank, or applicant for registration as a bank, is able to satisfy the Reserve Bank that it can meet the substance of the standard arrangements by alternative means. The following gives guidance on two specific cases where the Reserve Bank may agree that changes to the standard conditions are appropriate, and the factors it may take into account.
- a. In the case where the bank is owned by a holding company within a wider group structure, some of the objectives of the policy may be better achieved if the chair of the bank board also sits on the holding company's board. In this case, the bank may be subject to an alternative condition of registration on the role of the chair, that allows the chair not to satisfy the test for independence, but only to the extent of their membership of the holding company board.
    - i. The Reserve Bank would need to be satisfied that the chair's experience and background is such that they could be expected, when acting as a director of the holding company, to adequately contribute the subsidiary's perspective to the way that the group as a whole is run (within the constraint that their legal duty is to act in the best interests of the holding company itself). Factors having a bearing on this are likely to include the chair's New Zealand resident status.
    - ii. This variation would be allowed in relation to one holding company only, which in a group context would normally be the highest level company at which group-wide strategic decisions are considered.

- iii. For avoidance of doubt, in such cases the chair would not qualify as independent, but the condition of registration requiring the board to have a majority of independent directors would still apply.
- b. In the case where a registered bank's operations in New Zealand are very small, the conditions on the minimum board size and composition may be varied.
    - i. This is most likely to arise when the Reserve Bank is considering an application for registration for a New Zealand subsidiary of an overseas bank. The initial scale of operation of the subsidiary, in terms of number of employees and projected balance sheet size, may not for instance justify the requirement to have five directors.
    - ii. After an applicant has been registered as a bank, the Reserve Bank would keep the nature and scale of its operations under review, and would propose changes in the bank's conditions of registration on corporate governance, as appropriate to its growth over time, to bring them eventually into line with the standard conditions.
    - iii. The Reserve Bank would not normally vary the condition in respect of the audit committee.

## C. Guidelines

27. Guidelines follow, issued under Section 78(3) of the Act, on matters in relation to a bank's corporate governance arrangements that the Reserve Bank will take into account in
- a. having regard to the ability of an applicant for registration to carry on its business in a prudent manner; or
  - b. determining whether a New Zealand-incorporated registered bank has carried on its business in a prudent manner.

These guidelines cover matters that the Reserve Bank judges to be particularly worth highlighting in relation to the skills and experience of the board, and are drawn from the Basel Committee corporate governance principles referred to above.

28. These guidelines and the standard conditions of registration are not intended as an exhaustive list of matters the Reserve Bank regards as important for good corporate governance. Beyond complying with the requirements in the bank's conditions of registration and taking account of the following guidelines, it is the responsibility of the directors to satisfy themselves that the detailed corporate governance arrangements of the bank are appropriate to the particular nature of the bank's business and risks. The full text of the Basel document, and the Securities Commission Handbook referred to above, are comprehensive sources of guidance on the subject.

### *C.1 The guidelines [drawn from draft new Basel Principles]*

29. Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank. (*Basel Principle 2.*)

- a. This principle applies to a board member in his or her capacity as a member of the full board and as a member of any board committee.
30. The board should possess, both as individual board members and collectively, appropriate experience, competencies and personal qualities, including professionalism and personal integrity.
  31. The board collectively should have adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue in order to enable effective governance and oversight.
  32. To support board performance, it is a good practice for the board to carry out regular assessments of both the board as a whole and of individual board members. The board should periodically review the effectiveness of its own governance practices and procedures, determine where improvements may be needed, and make any necessary changes.
  33. To the extent that it is involved in identifying potential board members, the board should ensure that the candidates are qualified to serve as board members and are able to commit the necessary time and effort to fulfil their responsibilities.

#### **D. Public disclosure**

34. A registered bank must comply with the Reserve Bank's requirements for public disclosure in relation to corporate governance. These requirements apply to branches of banks incorporated overseas as well as to New Zealand-incorporated banks. Further, directors of a registered bank, and the New Zealand Chief Executive Officer for a registered bank incorporated overseas, must attest in disclosure statements that the registered bank has, at the reporting date and over the accounting period, complied with the requirements set out in the bank's conditions of registration.
35. The Reserve Bank's precise requirements for public disclosure are set out in the disclosure Orders in Council. The following summarises the corporate governance-related disclosure requirements applying to registered banks.
36. In the full and half year disclosures, the Orders require a registered bank to disclose the following –
  - a. The following information for each director: name; occupation(s); technical or professional qualifications; country of residence; whether they are executive; whether they are independent; other directorships held outside the banking group; and details of any transaction between the director or a closely-related party of the director, and any part of the banking group, which is not on an arm's length basis or could materially influence the director in carrying out their duties. In the case of branches, this information must also be disclosed in respect of the New Zealand Chief Executive Officer.
  - b. A statement whether there is a board audit committee, and if so, how many members it has in total, how many are independent directors, and how many are directors other than independent.
  - c. The board's policy for avoiding or handling conflicts of interest which may arise from any of the directors' personal, professional or business interests.

37. In the first and third quarter of the reporting year, the Orders require a registered bank to state whether there have been any changes in the composition of the board since the previous disclosure statement, and if so, the nature of the changes.

## Appendix 1 – Standard conditions of registration

In general, New Zealand-incorporated registered banks will be subject to the following conditions of registration.

1. That the registered bank complies with the following requirements in relation to corporate governance:
  - (a) the board of the bank has at least five directors;
  - (b) the board of the bank includes a majority of independent directors;
  - (c) if the bank’s constitution allows for directors to be represented by alternates, then any alternate who may act in place of an independent director must also be independent;
  - (d) a majority of the independent directors of the bank must be ordinarily resident in New Zealand;
  - (e) the chair of the bank is independent; and
  - (f) the bank’s constitution does not include any provision permitting a director, when exercising powers or performing duties as a director, to act other than in what he or she believes is the best interests of the company (ie the bank).

For the purposes of these requirements, the term “independent director” is defined in the Reserve Bank of New Zealand document entitled “Corporate Governance” (BS14) dated [month year].

2. That the registered bank has a board audit committee that meets the following conditions:
  - (a) the committee has at least three members;
  - (b) every member of the committee is a non-executive director of the bank;
  - (c) a majority of the members of the committee are independent; and
  - (d) the chair of the committee is independent and is not the chair of the bank.