CONSULTATION PAPER

GUERNSEY FINANCIAL SERVICES COMMISSION

GUIDELINES FOR CORPORATE GOVERNANCE AND RISK MANAGEMENT FOR BANKS

1. INTRODUCTION

1.1 All banks licensed under the Banking Supervision (Bailiwick of Guernsey) Law, 1994, as amended ("the Law") are required under section 36C of the Law to, inter alia, conduct an annual review of:

- the responsibilities and conduct of the bank's board of directors with respect to corporate governance principles;
- whether there has been effective control by the bank's board of directors over every aspect of risk management; and
- the bank's control environment
- whether the bank's financial record keeping systems and data systems are reliable
- whether any activity has been entered into in the course of the bank's business in respect of which no director of the bank has a sound knowledge.

1.2 The Guernsey Financial Services Commission ("the Commission") thus hereby issues these Guidelines for Corporate Governance and Risk Management for Banks ("the Guidelines") clearly articulating the Commission's expectations of a sound corporate governance regime.

1.3 The Board of Directors must report to the Commission any material deficiencies and problems identified by the review. They must provide a copy of the annual review to the Commission within such period as the Commission may require together with action plans and timetables to resolve any material deficiencies.

1.4 Corporate governance refers to all those steps needed to effectively oversee the direction and management of organisations and encompasses setting, controlling, monitoring and reviewing strategic direction, objectives, corporate values, delegation of responsibility and accountability, transparency and ethical behaviour. It involves defining the relationships between the Board of Directors, management team, shareholders and other stakeholders including depositors, staff and regulators.

1.5 The effectiveness of corporate governance by directors and senior management has a critical influence on bank viability. Good corporate governance practice improves safety and soundness through effective risk management and creates the ability to execute strategy and achieve business objectives in a manner that promotes confidence and protects the interest of depositors.

1.6 These Guidelines have been prepared as a statement of best practice for corporate governance and risk management at banks licensed by the Commission. They are not intended to be prescriptive, but are intended to provide direction and principles from which an approach to corporate governance appropriate to the circumstances of an individual bank can be developed and implemented. The approach to governance and risk management will reflect ownership, legal and operating structures.

1.7 It is the responsibility of the Board of Directors of banks operating as subsidiaries to determine which provisions of these Guidelines should be applied, taking into account the size, nature and complexity of business being undertaken by the bank. For branches, this responsibility lies with head office senior management of the bank and should be communicated to the Guernsey branch through the branch management committee or senior manager in Guernsey, depending on individual branch management arrangements.

2 THE APPROACH TO CORPORATE GOVERNANCE AND RISK MANAGEMENT

2.1 Assessment

2.1.1 The Board of Directors should assess and document whether their approach to corporate governance achieves its objectives and, consequently, whether the Board itself is fulfilling its own responsibilities. The Board of Directors should regularly assess the effectiveness of its overall approach to governance and make changes, as necessary where that effectiveness needs to be enhanced.

2.1.2 In its assessment, the Board of Directors should determine that:

- the bank's overall risk profile is sound and prudent and that risk is properly identified, measured and managed;
- new (or changes to) significant policies and procedures are appropriately reviewed and approved;
- the bank's internal controls provide reasonable assurance of the integrity and reliability of its records; safeguard, verify and maintain accountability for its on and off balance sheet assets and the proper recognition of income and expenditure properly recognise its on and off-balance sheet liabilities;
- internal controls are based on written and approved policies and procedures and are implemented by trained, skilled personnel whose duties have been segregated appropriately;

- adherence to the established internal controls is continuously monitored;

- the management information systems and accounting records are complete, accurate, and timely;

- issues of concern are identified and addressed and corrective action taken in a timely manner; and,

- all management and staff are required to maintain high corporate values and ethical standards, pursuant to the bank's established code of conduct.

2.1.3 The Board of Directors should assess whether the bank's control environment is appropriate and effective, taking into account the nature and scale of business of its approach to governance, management and style of communication, organisation structure, resource availability, procedures and controls.

2.1.4 The Board of Directors should determine whether the bank's capital is adequate for the nature and level of risks of the business. The Board of Directors and management should together consider and plan for the bank's current and prospective capital adequacy, through evaluation of projected capital needs, future profitability, implementation of an appropriate earnings retention policy and identification and assessment of the availability of external sources of additional capital.

2.1.5 Through such an assessment, the Board of Directors and management will demonstrate

- the overall effectiveness of their arrangement to protect the interest of depositors, creditors and other stakeholders;

- their ability to effectively identify, measure, manage and control significant business activities and the risks associated with those activities; and

- their ability to address risk and control issues raised through internal and external audit, relevant supervisory authorities and other sources.

2.1.6 The Board of Directors should engage the external auditor of the bank each year to review the general methodology followed by the Board in assessing the organisation's approach to corporate governance, including the management of risk, and to report directly to the Board and the Commission on whether any matters have come to their attention to suggest that they would not concur with the findings of the Board.

2.2 Corporate Governance

2.2.1 The Board of Directors should comprise executive and non-executive members and it should determine the mix and total number of Directors, as appropriate to the needs of the bank. The Board of Directors should act in the interests of the bank and exercise leadership, integrity, judgement and enterprise in directing the affairs of the bank. It is responsible for ensuring that an effective, comprehensive and transparent approach to corporate governance is in place, consistent with the nature, complexity and risks in the bank's business activities and which is able to respond to changes in the business environment. The Board of Directors need to identify their accountabilities to stakeholders of the bank, be committed to their interests, fulfilling their fiduciary responsibilities and communicate their approach to corporate governance as appropriate.

2.2.2 The Board of Directors is responsible for setting the strategic direction, corporate values and risk appetite of the bank. They should be proactive in recognising and understanding the risks the bank faces in achieving its business objectives and demonstrate effective and prudent management of those risks. The Board of Directors should establish appropriate risk management policies, procedures and controls. The Board may appoint supporting committees and engage management to assist it in fulfilling these responsibilities. The Board may delegate authority to management, but not its ultimate responsibility.

2.2.3 The Board of Directors should provide guidance to management and ensure that a comprehensive risk management system incorporating continuous identification, measurement, monitoring and controlling risk is developed, implemented and reviewed for effectiveness.

2.3 Risk management

2.3.1 The risk management system should use:

- accurate and reliable management information;
- relevant and timely risk analysis and reporting;
- thorough control standards, processes and programmes;

2.3.2 and include:

- separate and independent risk management and internal audit functions when appropriate to the nature and scale of business.
- oversight by external auditors;

2.3.3 The Board of Directors should review the risk management system and periodically and:

- obtain reasonable assurance that the bank has a continuing, appropriate and effective strategic management process;
- obtain reasonable assurance that the bank has continuing, appropriate and effective risk management arrangements;
- obtain reasonable assurance that the bank operates within an effective control environment;
- reassess the bank's business objectives, strategy and plans;
- review and approve all significant policies and procedures of the bank.

2.3.4 The conduct of the business of a bank entails the management of strategic, business, and process-level risks throughout the organisation on a consolidated basis. Depending on the specific types of businesses conducted by individual bank such risks (summarised in Appendix I) may include:

- credit risk
- concentration risk, country risk and transfer risk
- liquidity risk
- interest rate risk
- market risk
- settlement risk
- operational risk
- technology risk
- fiduciary risk
- strategic risk
- reputation risk
- outsourcing/third party relationship risk
- compliance risk
- legal risk
- staff risk
- business risk
- other risks that are identified as material to the particular business of the bank.

2.3.5 The Board of Directors and management should analyse existing and prospective businesses, products and services to identify and measure the types and significance of the current and potential risks to be managed and controlled, both individually and in the aggregate. The Board and management should develop and implement appropriate and prudent risk management policies and procedures and monitor their effectiveness through timely, accurate, relevant and complete information systems.

2.3.6 Programmes should also be developed to deal with extraordinary events. Comprehensive contingency plans addressing all significant risks identified in the organisation, should be put in place, tested and updated regularly.

2.4 Monitoring and evaluation of the approach to corporate governance and risk management

2.4.1 The overall effectiveness of the approach to corporate governance and risk management should be continuously monitored and periodically evaluated by the Board of Directors, either directly or through committees of the Board as appropriate. Such committees could include an executive committee, risk management committee, credit committee, asset and liability committee, audit committee, business acceptance committee, compliance committee, compensation committee, nominations committee, or other committees responsible for other specific aspects of business.

3. RESPONSIBILITIES OF THE BOARD OF DIRECTORS

3.1 Ensuring competent management.

3.1.1 To ensure the effective management of risk and meet corporate governance responsibilities the Board of Directors should:

- Clearly define and document its own authorities and responsibilities, including those of the Chairman, and of senior management.
- Establish standards of business conduct and ethical behaviour.
- Establish a comprehensive framework for, and oversee, management's setting and enforcing clear lines of responsibility and accountability throughout the organisation.
- Appoint a chief executive and other directors with integrity, technical and managerial competence and appropriate experience.
- Oversee and participate in the appointment of other senior executives with the skills necessary to manage and supervise the bank's business and staff.
- Set performance based compensation policies, programmes, goals and standards for senior management and review the compensation programmes established by senior management for other management and staff.
- Effectively supervise and evaluate management's performance.
- Develop and regularly update management succession plans.

3.1.2 Effective corporate governance requires a high level of co-operation between the Board of Directors and management. Management supervision is one of the Board's most direct responsibilities. The Board of Directors ensures that day-to-day operations are in the hands of qualified, honest and competent management and that managers understand their responsibilities. Management should be fully accountable to the Board of Directors. This means that the Board must monitor and evaluate management's actions and competence, require periodic setting and review of management's goals, and assess management's performance.

3.2 Approving objectives, strategies, plans and operating policies, standards, and procedures.

3.2.1 The Board of Directors should ensure that the bank has clearly established objectives and a strategy to achieve them. Business plans should be established to achieve its objectives and direct the day-to-day activities of the bank. The Board should approve these objectives, strategies and plans and ensure that performance against them is regularly reviewed, providing for necessary corrective action and redirection. The annual budgeting process and periodic reviews of budget performance is an integral part of any planning and performance monitoring process. The Board should approve budgets and review performance against those budgets. In addition, the overall operating policies, standards and procedures that govern the bank's day-to-day business activities should be periodically reviewed, revised and updated when necessary, and approved by the Board.

3.3 Ensuring that the bank's operations are conducted prudently and within the framework of laws, regulations and guidelines, as well as established policies and procedures.

3.3.1 The Board of Directors, advised by management, should ensure that the internal control systems of the bank are effective and that the bank's operations are properly controlled and comply with policies and procedures approved by the Board, with the Law, and with guidance and other regulatory and supervisory requirements of the Commission. The Board and management should consistently demonstrate their strong commitment to implementing an effective risk control environment throughout the organisation. The Board should ensure that management implements an effective, independent reporting and assessment process (i.e., internal audit or equivalent) to confirm to the Board the appropriate application of control policies and procedures. The Board should ensure that management takes corrective action when deficiencies are identified in the bank's control and compliance systems.

3.3.2 The Board of Directors should ensure that management develops, implements and oversees the effectiveness of comprehensive know-your-customer standards, including appropriate policies and procedures that address customer acceptance and identification, as well as ongoing monitoring of accounts and transactions, in keeping with the requirements of relevant law, regulations and guidance.

3.4 Ensuring and monitoring that the bank conducts its affairs with a high degree of integrity.

- The Board of Directors should ensure that the bank complies with the Commission's Code of Practice for Banks. It should set its own standards of business conduct and ethical values and communicate these throughout the entire organisation.

- The Board should establish procedures to identify, monitor, and manage:

  - Potential conflicts of interest of Board members, management and significant shareholders,

  - Abuses in related party transactions.

  - "Self-dealing" (i.e., the policies and controls on business conducted with related parties and the directors themselves), the potential misuse of corporate assets, or the possible use of privileged information for personal advantage.

- To ensure that necessary confidentiality is maintained and that the privacy of the organisation itself and its clients is not violated.

- To ensure that clients rights and assets are properly safeguarded, that no benefit can be gained from the improper use of confidential information, and that preferential treatment is not permitted.

3.4.1 The Board should also ensure that the organisation's compensation and benefits policies are consistent with its ethical values, objectives, strategies, business operations and control environment.

3.5 Reviewing business and operating performance.

3.5.1 The Board of Directors should regularly review financial statements and supporting analyses and explanations to ensure that they properly reflect the bank's underlying current and prospective financial condition and the status of its business plans.

3.6 Ensuring that the organisation is "in control."

3.6.1 The Board of Directors should determine that the bank can demonstrate that its operations, individually and collectively:

- are subject to effective governance and managed in accordance with appropriate, effective and prudent risk management processes;

- are supported by an appropriate control environment;

- effectively make use of the work of the internal (if used) and external auditors; and,

- identify significant issues related to the overall governance process and that appropriate, timely actions are taken to address issues of concern through the use of self-assessments, stress/scenario tests, and/or independent judgements made by external advisers.

4 DUTIES OF DIRECTORS

4.1 All directors of a bank have a duty to perform their functions with diligence and care and with such degree of competence as can reasonably be expected from persons with their knowledge and experience.

4.2 All directors of a bank have a duty to ensure that the risks undertaken by the bank in the conduct of its business are managed in a prudent manner.

4.3 All directors of a bank have a duty to require that management provide them with adequate, appropriate and substantive information on the activities and operations of the bank.

4.4 All directors of a bank should have a basic knowledge and understanding of the conduct of the business of the bank and the laws, regulations, guidelines, other regulatory requirements, and the customs and practices that govern that business. Although not every director is expected to be fully conversant with every aspect of the business of the bank, the competence of every director should be commensurate with the nature and scale of the overall business. Directors should work to acquire the knowledge and skills necessary to effectively perform their functions on assigned specialised committees of the Board, if such committees are used.

4.5 All directors, in exercising any authorities of a director or discharging any of their duties as a director should:

- act with honesty, integrity and good faith with the view to the best interests of the bank and its stakeholders;

- exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances;

- exercise independent judgement in their approach to decision making and problem solving;

- act on a fully informed basis;

- understand and devote sufficient time to their responsibilities
- act only within the scope of their authority; and,
- recognise and guard against conflicts of interest in dealing with the bank, taking into account the interests of all stakeholders.

5 OPERATIONS OF THE BOARD OF DIRECTORS

5.1 The Board of Directors should meet no less than once every quarter.

5.2 The Board of Directors may supervise major functional areas through specialised committees of the Board and/or committees comprising directors and appropriate senior management, while still ensuring that the full Board remains fully knowledgeable of the affairs of the bank and is ultimately responsible for the decisions of each committee. The use of such committees should be dictated by the complexity of business activities of the bank. To be effective, such committees should meet regularly as the needs of their particular responsibilities dictate.

5.3 Committees, when used, should be established with clearly defined objectives, authorities, responsibilities, and tenure and the requirement that they report regularly to the full Board of Directors. The Board should ensure that the structure of each committee is suitable to the bank's nature and scale of business activities, the Board's composition, and each individual director's expertise.

5.4 The Board of Directors should establish appropriate methodologies for the Board's direct and indirect oversight of the management of significant areas of risk exposure; e.g., management of credit risk, liquidity, capital adequacy, compliance, control systems, audit, etc. Additionally, the Board should assign non-executive directors to those committees, if they are used, for particularly sensitive areas where a potential for conflict of interest exists (e.g., the executive committee and the audit committee).

5.5 The Board of Directors should periodically reconstitute itself and its committees, if any, by selecting new directors to replace long-standing members or those whose contribution to the organisation or the committees is not adequate.

APPENDIX I

SYNOPSIS OF RISKS

Credit Risk - The risk to earnings or capital arising from the potential that a borrower or counterparty will fail to perform on an obligation.

Concentration risk, Country Risk and Transfer Risk - The risk to earnings or capital arising from potential that a concentration of exposure to individual customers or economic sectors fails to perform on an obligation. Country Risk is the risk to earnings and capital arising from the effects on business activities of trends and movements in the economic, social, and political conditions in a country. Transfer Risk focuses specifically on the availability of foreign exchange to service cross-border obligations.

Liquidity Risk - The risk to earnings or capital arising from the potential that an organisation will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding, or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions.

Interest-Rate Risk - The risk to earnings or capital resulting from adverse movements in interest rates.

Market Risk - The risk to earnings or capital resulting from adverse movements in market rates or prices, assessed based on consideration of the interaction between market volatility and the organisation's business strategy.

Strategic Risk - The current and prospective impact on earnings or capital arising from faulty business strategies and decisions, improper implementation of strategies and decisions, or lack of response to industry changes.

Fiduciary Risk - The risk to earnings and capital resulting from a breach of duty in advising on, or in holding, administering, managing or investing the assets of a client or other third party.

Operational Risk - The risk to earnings or capital arising from inadequate or failed internal processes, people and systems and external risks.

Reputation Risk - The risk to earnings or capital arising from the potential that negative publicity regarding an organisations business or ethical practices will cause a decline in the customer base, or revenue or costly litigation. Such risk often arises from the mismanagement of other risks.

Settlement Risk - The risk to earnings or capital arising when the completion or settlement of a financial transaction fails to take place as expected. Settlement risk is often associated with credit risk, liquidity risk, operational risk and reputation risk.

Technology Risk - The risk to earnings or capital arising from inadequate, obsolete, or mismanaged technology or from a failure or interruption in technology caused by events within or outside the organisation.

Outsourcing/Third-Part Relationship Risk - The risk to earnings or capital arising from a decline in service quality, accuracy, security or response time on the part of a third party that provides products and services that the organisation would otherwise provide for itself.

Compliance Risk - The risk to earnings or capital arising from breach, or non-compliance with, laws, regulations, guidelines, other regulatory directives, prescribed business practices or ethical standards.

Legal Risk - The risk to earnings or capital arising from the potential that unenforceable contracts, lawsuits or adverse judgements may disrupt or otherwise negatively affect the operations or financial condition of the organisation.

Staff Risk - The risk to earnings or capital arising from the inadequacies in the competencies, capabilities or performance of an organisation's personnel, failure to provide for management succession or staff back-up, or human error, negligence or misconduct.

Business Risk – The risk to earnings or capital arising from the impact of external factors on a previously sound rationale for a business line.

APPENDIX II

Reference Materials

Basel Committee on Banking Supervision

Enhancing Corporate Governance in Banking Organisations (September 1999)

http://www.bis.org/publ/bcbs56.pdf

Framework for Internal Control Systems in Banking Organisations (September 1998)

http://www.bis.org/publ/bcbs33.pdf

Canada Deposit Insurance Corporation

Standards of Sound Business and Financial Practices with Commentary

http://www.cdic.ca/Standards/

The Central Bank of the Bahamas Bank Supervision Department

Guidelines for the Corporate Governance of Banks and Trust Companies licensed to do business within and from the Bahamas

http://centralbankbahamas.com/public/bsdguidecorpgov.pdf

Banking: An Industry Accounting and Auditing Guide (Industry Accounting and Auditing Guides). John Hitchins, David Mallett, Mitchell Hogg. (AGB Publications)