College of Graduate Studies
Hebron University

The Impact of Corporate Governance on the Financial Performance of Banks Listed on Palestine Exchange

Samer Yahya Abd Alazeem Doufesh

M.Sc. Thesis

Hebron – Palestine

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Thesis Submitted in Partial Fulfillment of Requirements
for the Degree of Master of Management,
College of Graduate Studies, Hebron University

1437 / 2016

Hebron University
Deanship of Graduate Studies
Master Program in Management

Thesis Approval

The Impact of Corporate Governance on the Financial Performance of Banks Listed on Palestine Exchange

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Master thesis submitted and accepted on 23/3/2016.

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Hebron – Palestine

1437 / 2016

DEDICATION

I Dedicate This Effort To My
Family Members, Instructors, and Friends

Declaration:

I certify that this thesis submitted for the degree of Master is the result of my own research, except where otherwise acknowledged, and that this thesis (or any part of the same) has not been submitted for a higher degree to any other university or institution.

Signature:

Samer Yahya Abd Alazeem Doufesh

Date:23/3/2016

ACKNOWLEGEMENT

First of all, I would like to express my sincere gratitude to my advisor Dr. Yasser Shaheen for his continuous support, patience, motivation, and immense knowledge. Without his guidance and help, this thesis would not have been possible. Besides my advisor, I would like to thank the rest of thesis committee members for their insightful comments and encouragement.

Last but not the least, I would like to thank my family members for supporting me spiritually throughout writing this thesis in particular and during my life in general.

ABSTRACT

The main objective of this study is to examine the impact of corporate governance on the financial performance of banks listed on Palestine Exchange (PEX). Corporate governance is measured using board size, board meeting frequency, board committees, CEO status, and ownership structure. Meanwhile, return on assets (ROA) and return on equity (ROE) are used as a measure of the financial performance. The methodology used for analyzing data is based on the quantitative techniques such as descriptive statistics, bivariate correlation, and independent samples t-test.

The secondary data for the study were obtained from the published annual reports of banks listed on the Palestine Exchange for the eight years period from 2007 to 2014. The Pearson correlation and the t-test are used to find out whether there is a relationship between the corporate governance variables and the financial performance of bank listed on Palestine Exchange.

The results indicate that board meeting frequency and CEO status have a significant impact on the financial performance of banks listed on Palestine Exchange. Specifically, banks that hold more board meetings per year tend to achieve better financial performance in terms of both return on assets (ROA) and return on equity (ROE).

In addition, banks in which the CEOs are also board members (CEO duality) generate, in general, higher financial performance in terms of return on assets (ROA) and return on equity (ROE) than banks in which CEOs are independent from the board. On the other hand, board size, board committees, and ownership structure have no significant impact on the financial performance of banks listed on Palestine Exchange.

According to the results of study, the researcher recommends improving corporate governance practices by imposing mandatory compliance with the code of corporate governance, complying with the rules of corporate governance in the areas of board of directors, board committees, and ownership structure, and conducting further studies that take into consideration sectors other than the banking sector and variables that are not dealt with in this study.

الملخص

أثر حوكمة الشركات على الأداء المالي للبنوك المدرجة في بورصة فلسطين

تهدف الدراسة إلى فحص أثر حوكمة الشركات على الأداء المالي للبنوك المدرجة في بورصة فلسطين. وقد تم قياس حوكمة الشركات باستخدام عدد أعضاء مجلس الإدارة، وعدد اجتماعات المجلس، وعدد اللجان المنبثقة عنه، ووضع الرئيس التنفيذي، وهيكل الملكية. ومن ناحية أخرى، تم استخدام معدل العائد على الأصول ومعدل العائد على حقوق الملكية لقياس الأداء المالي للبنوك. واعتمدت المنهجية التي تم استخدامها لتحليل البيانات على الأساليب الكمية مثل الإحصاءات الوصفية، ومعامل ارتباط بيرسون، واختبار (t) للعينات المستقلة.

قد تم الحصول على البيانات الثانوية للدراسة من التقارير السنوية الصادرة عن البنوك المدرجة في بورصة فلسطين لفترة الثماني سنوات الممتدة من عام 2007 إلى عام 2014. وتم استخدام ارتباط بيرسون واختبار (t) لاختبار فيما إذا كانت هناك علاقة بين متغيرات حوكمة الشركات والأداء المالي للبنوك المدرجة في بورصة فلسطين.

تشير نتائج الدراسة إلى أن عدد اجتماعات مجلس الإدارة ووضع الرئيس التنفيذي لهما أثر ذو دلالة إحصائية على الأداء المالي للبنوك المدرجة في بورصة فلسطين. وعلى وجه التحديد، تحقق البنوك التي تعقد اجتماعات مجلس إدارة أكثر في السنة أداءً مالياً أفضل من حيث العائد على الأصول والعائد على حقوق المساهمين. تحقق البنوك التي يكون الرؤساء التنفيذيون فيها هم أيضاً أعضاء مجلس إدارة ، بشكل عام ، أداءً مالياً أعلى من حيث العائد على الأصول والعائد على حقوق المساهمين من البنوك التي يكون الرؤساء التنفيذيون فيها مستقلين عن مجلس الإدارة. وفي المقابل، لا يوجد أثر ذو دلالة إحصائية لكل من عدد أعضاء مجلس الإدارة، وعدد اللجان المنبثقة عن المجلس، وهيكل الملكية على الأداء المالي للبنوك المدرجة في بورصة فلسطين.

بناءً على نتائج الدراسة التي تم التوصل إليها فإن الباحث يوصي بتحسين ممارسات حوكمة الشركات من خلال فرض الامتثال الإلزامي لمدونة قواعد حوكمة الشركات، والامتثال لقواعد الحوكمة في مجالات مجلس الإدارة، ولجان المجلس، وهيكل الملكية، وإجراء المزيد من الدراسات التي تأخذ بعين الاعتبار القطاعات الأخرى غير القطاع المصرفي والمتغيرات التي لم يتم تناولها في هذه الدراسة.

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LIST OF ABBREVIATIONS

AC:	Audit Committee
BC:	Board Composition
BS:	Board Size
CEO:	Chief Executive Officer
CGIs:	Corporate Governance Indices
CSE:	Colombo Stock Exchange
EPS:	Earnings per Share
GLS	Generalized Least Squares
HR:	Human Resources
IFRS:	International Financial Reporting Standards
IT:	Information Technology
KPIs:	Key Performance Indicators
M/B:	Market to Book Value
NSE:	Nigerian Stock Exchange
OECD:	Organization for Economic Cooperation and Development
P/E	Price/Earnings Ratio
PCMA:	Palestine Capital Market Authority
PM:	Profit Margin
PMA:	Palestine Monetary Authority
PSE:	Palestine Securities Exchange
ROA:	Return on Assets
ROE:	Return on Equity
ROI:	Return on Investment
SPSS:	Statistical Package for the Social Sciences
VA:	Value Added
VAIC:	Value Added Intellectual Coefficient

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CHAPTER ONE
GENERAL FRAMEWORK OF STUDY

1.1 Introduction

Corporate governance has recently received considerable attention from local, regional, and global companies and institutions all over the world. According to the Organization for Economic Cooperation and Development (OECD), corporate governance is defined as "the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company's objectives are set and the means of attaining those objectives and monitoring performance"(OECD, 2004).

Therefore, good corporate governance practices are critical to the proper functioning of the economy in general and the banking sector in particular. Specifically, good corporate governance maintains investors' confidence, lowers the cost of capital, minimizes wastages, corruption, risks and mismanagement, enhances share price and, as a result, ensures corporate success and growth(Basel Committee on Banking Supervision, 2014).

Otherwise, corporate governance weaknesses at banks, which play a vital role in the financial system, can lead to the spread of problems across the banking sector and the economy as a whole.

Financial performance of banks is of great importance to stakeholders in general and shareholders in particular since it is a main source of financing and the basis for dividends payout. Therefore, identifying and analyzing the factors that might impact financial performance of banks is of great importance (Muller, 2014).

Given this background, this study aims to empirically examine the impact of applying corporate governance practices on the financial performance of banks in Palestine.

1.2 Problem Statement

Issues regarding corporate governance practices are an inherent weakness in many developing countries including Palestine. Better corporate governance enables efficient and effective working environment and it also ensures high levels of accountability and transparency.

Thus, the impact of applying corporate governance practices on companies' financial performance has recently been an important topic of study. Therefore, the main idea of this study is to examine the impact of applying corporate governance practices on the financial performance of banks listed on Palestine Exchange.

In Particular, the study is conducted to answer the following questions:

1. Are board size and the financial performance of Banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) correlated?

2. Are board meeting frequency and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA)and return on equity (ROE) correlated?
3. Are board committees and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) correlated?
4. Are CEO status and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) correlated?
5. Are ownership structure and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) correlated?
6. Do board size, board meeting frequency, board committees, CEO status, and ownership structure affect the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).

1.3 Importance of Study

This study derives its importance from the following points:

1. Good corporate governance is critical to the proper functioning of the banking sector in particular and the economy in general. Therefore, corporate governance in banking institutions has recently been a priority on the policy agenda in developed countries as well as developing countries. Palestine is not an exception in this case.
2. Corporate governance characteristics that might affect financial performance of banks are of great importance to stakeholders in general and shareholders in

particular. As a result, the study provides evidence of whether corporate governance and bank financial performance in Palestine are related.

3. Corporate financial scandals all over the world have given an increasing attention to corporate governance issues since effective corporate governance practices tend to reduce risks and financial crisis in the banking sector.
4. Effective corporate governance practices tend to reduce risks and financial crisis in the banking sector.
5. The study provides evidence of whether corporate governance and bank performance in Palestine are related.
6. Lack of corporate governance studies in Palestine in general and particularly in the banking sector.

1.4 Objectives of Study

The main objective of this study is to explore the impact of corporate governance on the financial performance of banks listed on Palestine Exchange. However, the specific objectives are as follows:

1. To investigate the correlation between board size and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).
2. To investigate the correlation between board meeting frequency and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).

3. To investigate the correlation between board committees and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).
4. To investigate the correlation between CEO status and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).
5. To investigate the correlation between ownership structure and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).
6. To investigate the impact of board size, board meeting frequency, board committees, CEO status, and ownership structure on the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).

1.5 Hypotheses of Study

In order to examine the impact of corporate governance on the financial performance of banks listed on Palestine Exchange, the following hypotheses are tested:

H1: Board size and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

H2: Board meeting frequency and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

H3: Board committees and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

H4: Financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA) and return on equity (ROE) differs according to CEO status.

H5: Ownership structure and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

H6: Board size, board meeting frequency, board committees, CEO status, and ownership structure will significantly explain the variance in the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE).

1.6 Scope of Study

Although the study is an important contribution in the field of corporate governance and the financial performance of banks listed on Palestine Exchange, the scope of study is limited to the following:

1. The study considered only the banking sector in Palestine. Other studies may consider other sectors such as manufacturing, insurance, investment, and service.
2. The study covered the eight years period from 2007 to 2014. This period is considered in the study due to availability of necessary data.
3. The Palestinian public shareholding banks listed on Palestine Exchange participated in the study rather than all banks operating in Palestine.
4. Corporate governance is measured using a proxy that consists of five aspects. Namely, board size, board meeting frequency, board committees, CEO status, and ownership structure. However, there are other factors that may affect the state of

corporate governance in banks. These five aspects are used as a proxy to corporate governance for two reasons. First of all, they are considered to be the most important corporate governance variables. Second, there is no generally accepted corporate governance index in Palestine that takes into account all the corporate governance variables.

5. Bank performance is measured using both return on assets (ROA) and return on equity (ROE). Other key performance indicators (KPIs) such as the price earnings ratio (P/E) may also be used to measure bank performance.

CHAPTER TWO
LITERATURE REVIEW ANDTHEORITICAL FRAMEWORK

2.1 History of Corporate Governance

Corporate governance systems have evolved over centuries, often in response to corporate failures or systemic crises. The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in England. Similarly, much of the securities law in the U.S. was put in place following the stock market crash of 1929 (International Finance Corporation, 2010).

There has been no shortage of other crises, such as the secondary banking crisis of the 1970s in the U.K., the U.S. savings and loan debacle of the 1980s, the 1998 financial crisis in Russia, the 1997-1998 financial crisis in Asia (especially in Indonesia, South Korea and Thailand) and the current global financial crisis which started in 2008 (International Finance Corporation, 2010).

The history of corporate governance has also been punctuated by a series of well-known company failures. The early 1990s saw the Maxwell Group raid the pension fund of the Mirror Group of newspapers and witnessed the collapse of Barings Bank. The new century likewise opened with a bang, with the spectacular collapse of Enron in the U.S., the near-bankruptcy of Vivendi Universal in France, the scandal at Parmalat in Italy, the trading fraud which hit Société Générale and the most recent Madoff multi-billion dollar Ponzi scheme, make other scandals pale in comparison (International Finance Corporation, 2010).

Each of these corporate failures, often occurring as a result of incompetence or outright fraud, was swiftly met by new governance frameworks, most notably the many national corporate governance codes, the Sarbanes-Oxley Act (2002) and the current trend towards imposing stricter regulatory oversight on banking and financial activities in various countries (International Finance Corporation, 2010).

It is fair to say that, although there is still plenty of room for improvement, the legal and regulatory framework on corporate governance has changed and improved dramatically in recent years (International Finance Corporation, 2010).

Some highlights in the history of corporate governance are presented in Appendix A.

2.2 Concept of Corporate Governance

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (OECD, 2015).

According to the Organization for Economic Cooperation and Development (OECD, 2004), corporate governance structure specifies the distribution of rights and responsibilities among different participants such as the shareholders, boards, managers and other stakeholders in the corporation and spells out the rules and procedures for making decisions on corporate affairs.

Corporate governance refers to how organization is run, that is, how the resources of an organization are employed in pursuance of the goals of the organization (Chienjien, 2010).Corporate governance includes corporate discipline, transparency, independence, accountability, fairness, social responsibility, timely and accurate disclosure of all material matters relating to the company including the financial performance, ownership and governance arrangements (Hassan, 2010).

Moreover, good corporate governance regulates the relationship between stakeholders, their boards' members and management team (Hassan 2010).It is also defined as a "Process through which shareholders induce management to act in their interests, providing a degree of investor confidence that is necessary for the capital markets to function effectively" (Rezaee, 2009).

According to Oladejo (2008), corporate governance includes the relationship between stakeholders, creditors and corporations; between financial markets, institutions and corporations; and between employees and corporations. Corporate governance also encompasses the issue of social responsibility, including such aspects as dealing of firms with culture and the environment.

The concept of corporate governance is mainly concerned with applying customs, policies, system, laws and regulations in organizations (Alo, 2007).

Corporate governance can be defined as the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation (Wheelen & Hunger, 2006). It also includes the relationship among the many players involved and the goals for which the corporation is governed. The principal players are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

Corporate governance can also be stated as the set of rules and procedures that ensure that managers do indeed employ the principles of value based management (Brigham & Ehrhardt, 2005).

Melvin and Hirt (2005) described the concept of corporate governance by referring to corporate decision-making and control, particularly the structure of the board and its working procedures. It is also sometimes used very widely, embracing a company’s relations with a wide range of stakeholders or very narrowly referring to a company’s compliance with the provisions of best practice codes.

Low (2003) views corporate governance as mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management in such a way that their interests are protected. Metrick and Ishii (2003) view corporate governance from the investors’ perspective as "both the promise to repay a fair return on capital invested and the commitment to operate a firm efficiently".

Metrick and Ishii (2002) identified four dimensions of corporate governance at the level of the firm that can help to minimize the agency probable: board of directors, ownership structure, executive incentive contracts, and charter and bye law provisions. Finally, Thomas (2002) described corporate governance in the ways and means by which the government of a company (the directors) is responsible to its electorate (the shareholders).

In this study, the corporate governance definition of the OECED is adopted.

2.3 Corporate Governance and Corporate Performance

Several academic papers investigated the relationship between corporate governance characteristics and corporate performance. In this section, a brief review of these papers is presented.

Abu Awwad and AlKababji (2014) conducted an empirical study to investigate the effect of corporate governance on the financial performance of Palestinian commercial banks. The study consisted of two sections. The first one is a descriptive study which inspects the extent to which corporate governance is applied in local Palestinian commercial banks by adapting the Credit Lyonnais Securities Asia-CLS Model for the classification of banks according to three levels of institutional corporate governance: low, medium, and high. The second section is an applied study which examines the impact of corporate governance on the financial performance of local Palestinian commercial banks using a sample of seven local banks.

The descriptive section showed that there is a possibility to adapt the Credit Lyonnais Securities Asia-CLS Model for the classification of local Palestinian commercial banks according to three levels of institutional corporate governance as there is wide variation between them.

The applied section indicated a clear impact of corporate governance on the three indicators of financial performance: return on assets (ROA), return on equity (ROE), and profit per share. By contrast, there was no effect of corporate governance on the price to earnings per share ratio.

Based on the results, the study recommends that the Credit Lyonnais Securities Asia-CLS Model should be developed to measure corporate governance of various institutions in Palestine, so it would be a benchmark standard for the level of corporate governance.

Muller (2014)conducted a study in the UK to investigate, using econometric regression models, the impact of 9 corporate governance characteristics regarding board composition on the contemporaneous and next year's performance measured as return on assets (ROA) using a sample comprised of the constituents of FTSE100 between 2010 and 2011.

The researcher intended to contribute to the academic literature on the unsettled issue concerning the relationship between corporate governance and corporate performance. As hypothesized and in accordance with some previous researches the study found that board independence and the proportion of foreign directors in the total number of directors (as characteristics of corporate board composition) have a significant strong positive impact on firm performance.

Burqiba and Gherbi (2014) conducted a paper to determine the relationship between the variables of corporate governance and financial performance of Islamic banks. The authors measured the impact of corporate governance variables on financial performance through an empirical study on a sample of 10 Islamic banks during the period 2005-2012.

The financial performance of banks is measured using return on assets (ROA) while corporate governance is measured using board composition, board size, board committees, ownership concentration, and Sharia supervisory board.

The study found that there is a very strong relationship between the variables of governance and the financial performance of Islamic banks. Specifically, the study found a positive relationship between return on assets (ROA) and the composition of the board of directors, the size of the board, the number of committees in the board, as well as the number of members of the Sharia Supervisory Board. On the other hand, the study found a negative relationship between return on assets (ROA) and ownership concentration variable.

Almanaseer (2013) conducted a study to assess the effect of implementing corporate governance on the performance of public shareholding service companies in Jordan. The researched utilized the survey formulate by the Jordan Securities Commission in order to measure the extent to which companies are implementing corporate governance rules. The survey contains four groups of rules. These rules are the board rules, general assembly meeting rules, shareholder equity rules, and disclosure and transparency rules.

The performance of public shareholding companies is measured using financial ratios such as return on assets (ROA), return on equity (ROE), earnings per share (EPS), market to book value (M/B) and price to earnings ratio (P/E). The study found no statistical significant impact of implementing corporate governance rules on any of the financial ratios.

Guo and Kumara (2012) conducted a study in Sri Lanka to examine the relationship between corporate governance structures and firm performance of listed firms on Colombo Stock Exchange (CSE). Independent variables considered are board size, proportion of non-executive directors in a board, director's shareholdings, and CEO duality. The Return on Assets (ROA) and Tobin's Q are used as performance measurements and firm size measured by turnover is used as the control variable in the study.

Data were collected from 174 firms in the financial year 2010 and multiple regression analysis was used to examine whether the existing corporate governance mechanisms influence the firm performance of listed firms in Sri Lanka.

The study suggested a marginal negative association between board size and value of the firm and a negative impact of the proportion of outside directors on operating performance of company. Moreover, firm size and director shareholdings have a significant impact on firm performance of listed firms in Sri Lanka.

Price et al. (2011) conducted a study in Mexico to examine the relation between compliance with the code of best corporate practice and performance. The code was developed to provide information to market participants regarding the governance strength of firms trading on the Mexican stock exchange.

The results indicated that compliance is generally not associated with improved performance, suggesting that monitoring alone is not enough to bring about fundamental changes.

Sami et al. (2011) conducted a research paper to investigate the impact of corporate governance on firm performance and valuation in China. The study introduced a composite measure of corporate governance to measure the association between corporate governance and Chinese firms' performance and valuation. Because agency theory suggests that companies with better corporate governance standards perform better, the authors proposed that better governed Chinese firms would have greater performance and higher valuation.

The study found that the composite measure of corporate governance is positively and significantly associated with firm performance and valuation. These findings have implications for policy makers, researchers, managers, and investors in general and those in emerging markets in particular.

A study of Jordanian commercial banks confirmed that ownership concentration is an effective determinant of operational performance (Al-Hawary, 2011). According to agency theory, ownership concentration leads to increase the performance and reduce the agency problems.

Ahmad (2010) conducted a study to examine the impact of corporate governance on performance of banks in Palestine using financial ratios, namely the return on assets (ROA). Cross sectional and time series data were used. The generalized least squares (GLS) regression was used.

The primary findings indicated that the board size, CEO duality, internal ownership, and the bank age have significant positive impact on the performance of banks. Meanwhile, the board hierarchy, family ownership, bank size and debt ratio have a significant negative relationship with performance. Moreover, it is found that both the board size and the internal ownership have the most considerable influence on the performance of banks in Palestine.

Abidin and Camal (2009) conducted a study to examine the association between board structure and corporate performance, where performance is defined as the value added (VA) efficiency of the firm's physical and intellectual resources rather than the more commonly used financial terms or profitability ratios. It is argued that the inclusion of intellectual elements into the measurement provides a long-term measurement of corporate performance. The VA efficiency of the firm's total resources is calculated using the Value Added Intellectual Coefficient (VAIC) methodology developed by an Austrian, Ante Pulic. The four board characteristics that are of interest in this study are board composition, directors' ownership, CEO duality and board size.

Based on a randomly selected sample of 75 companies listed on Bursa Malaysia, it is found that board composition and board size have a positive impact on firm performance, while the effects of directors' ownership and CEO duality on the VA efficiency of firm's total resources are not established.

The outcome of the study shows that the emphasis on the importance of outside directors on the board by The Malaysian Code on Corporate Governance and by the requirements of Bursa Malaysia is deemed pertinent to the long-term corporate performance.

Bauwhede (2009) examined the relationship between corporate governance and corporate performance. The author reported evidence of a positive relationship between the extent of compliance with international corporate governance best practices regarding board structure and functioning and operating performance as measured by the return on assets (ROA). According to the author, it is especially the structure and functioning of the corporate board that can directly impact the operating efficiency and operating performance of a company.

The study of Guest (2009) examined the influence of board size on company performance for a large sample of UK listed firms during 1981-2002. The results indicated that board size has a strong negative impact on performance as measured by profitability, Tobin's Q and share returns.

Kajola (2008) conducted a research to examine the relationship between corporate governance and firm performance in Nigeria. Corporate governance components included board size (BS), board composition (BC), CEO status, and audit committee (AC). Measures of return on equity (ROE) and profit margin (PM) were used to assess the performance of the firm.

The data used for the study were derived from audited financial statements of firms listed on the Nigerian Stock Exchange (NSE). A sample of 20 Nigerian listed firms from 2000 to 2006 was selected using the combination of non-probability sampling and stratified random sampling techniques.

The ordinary least square method of estimation was used. The results provided evidence of positive significant relationship between return on equity (ROE) and board size. However, the study did not clarify a significant relationship between the two performance measures and audit committee.

Bhagat and Bolton (2008) estimated the relation between corporate governance and firm performance. The authors found that better corporate governance is significantly positively correlated with both better current and better subsequent operating performance but not with stock market performance.

Qubbaja (2008) conducted a study to investigate the impact of corporate governance effectiveness on the financial performance of listed companies on the Palestine Securities Exchange (PSE). A Stratified random sample of 20 companies was selected from a total of 28 companies listed on the Palestine Securities Exchange (PSE) in 2005, which also continued to be listed until the end of 2006.

Simple and multiple regressions were used to determine the impact of the independent variable that represented the corporate governance effectiveness on the dependent variable which in turn represented financial performance as measured by return on equity (ROE), return on investment (ROI), price earnings ratio (P/E), market to book value (M/B), Tobin's Q and daily stock volatility.

The study found a statistical significant positive relationship between corporate governance effectiveness on one side and return on equity (ROE), return on investment, price earnings ratio (P/E), market to book value (M/B), Tobin's Q and daily stock volatility on the other side. A negative statistical significant relationship between corporate governance effectiveness and daily stock volatility was found.

Matar and Nour (2007) conducted a study that aims at evaluating the extent to which Jordanian shareholding companies comply with the principles of corporate governance. To achieve this objective, the researchers conducted a field study on a sample of (20) shareholding companies working in the banking and industrial sectors. The sample represents about 32% of the population size.

A questionnaire containing six questions which cover the six principles of corporate governance was distributed to explore the sample's opinion about how much Jordanian shareholding companies comply with those principles. In analyzing data, the researchers used the descriptive statistical indicators, in addition to two kinds of statistical tests: t-test for one sample and the Mann-Whitney test.

The major findings of the study were that while those companies stick with corporate governance principles within a range between very weak and strong levels, but generally they, as one unit, stick with those principles at a moderate level. The study also found that some companies use illegal methods such as bribes and patronage to gain contracts, and found that some companies do not stick to ethical rules and social responsibility obligations. This is usually done through boards of directors.

The study recommended that the control bodies of Jordanian companies publish a guide discussing the essential rules of principles of corporate governance to encourage them to form committees for corporate governance of independent members, similar to auditing committees at work in these companies.

Rogers (2006) conducted a study to explore the relationship between the core principles of corporate governance and financial performance in commercial banks of Uganda. Results indicated that corporate governance predicts about 35% of the variance in the general financial performance of commercial banks in Uganda.

Shaheen and Nishat (2005) suggested that those firms that do not follow good governance do not get higher profits. Effective and strong corporate governance practices pave way for success while the organization with week governance practices get less financial benefits.

Gompers et al. (2003) conducted a study to examine the impact of corporate governance on firm performance during the 1990's. Using 24 governance rules, the authors constructed a corporate governance index to be used as a proxy for the level of shareholder rights. The results indicated that companies with stronger shareholder rights had higher firm value, higher performance and higher sales growth than companies with weak shareholder rights.

However, in a subsequent paper, Core et al. (2006) showed that in the first decade of this century, firms with strong shareholder rights do not outperform firms with weak shareholder rights.

The OECD Advisory Group (2004) concluded that good corporate governance increases operational performance. For Claessens (2003), it also increases access to external financing by firms, lowers the cost of capital and increases operational performance.

According to the study, one of the basic elements of corporate governance is the board of directors. The board of directors is the top executive unit of a bank. It is charged with defining strategies and supervising performance. Many scholars consider the board's structure as an indicator to evaluate the efficiency of corporate governance specifically through dimensions of size, independence and CEO duality.

Wolfgang (2003) illustrated that good corporate governance lead to increased valuation, higher profit, higher sales growth and lower capital expenditure. Adams and Mehram (2002) also examined the effect of board size and board composition as measures of corporate governance on value. Their results indicated the absence of concrete relationship between board composition and value and a positive relationship between board size and value.

Klapper and Love (2002) examined the relationship between corporate governance and performance in a sample of firms from 14 countries, most of which are developing economies. They found that better corporate governance practices are associated with better performance in terms of Tobin's Q and return on assets (ROA) and that good governance seems to matter more when the legal environment of a county provides investors with weaker protections.

Numerous studies found that size of the board of directors is inversely related to firm value (Jensen and Meckling, 1976; Jensen, 1993; Yermack, 1996; Hermalin and Weisbach, 2003; Mak and Kusnadi, 2004; Cheng, 2008; Adusei, 2011; Chang and Dutta, 2012). In the banking sector, Agorakiet al. (2007) have shown a negative relation between board size and the performance of 58 European banks.

Pathan et al. (2007) investigated the relationship between board size and bank performance in Thailand during the period 1999-2003. They found significant and negative impact of board size on bank performance. The board efficiency is reduced if the number of members is too large. In a small board, the members are likely to be engaged and more active which leads to more efficiency and speed.

Krivogorsky (2006) reported a positive effect of independence of board member on firm performance in several European countries. Based on a sample of 69 banks from Germany, UK, Spain, France, and Italy, Busta (2007) showed that banks with a higher presence of independent members in their boards perform better in term of the market-to-book value. For the author, the independent directors are more professional in decision making and can more easily achieve the supervising function, reduce the possibility of collusion of top executives and improve the operating performance.

Worrell et al.(1997) revealed a negative impact of CEO duality on stock price. Mishra and Nielsen (2000) reported a significant negative relationship between CEO duality and bank performance which suggest a managerial entrenchment in the form of CEO duality. As such, the absence of duality decreases the risk of principal conflict. In 2010, Li and Tang pointed out that CEO duality increases risk taking of Chinese firms.

In the case of commercial banks in Turkey, Kaymak and Bektas (2008) found that CEO duality has a negative impact on return on assets (ROA). In 2010, Agoraki et al. confirmed a negative relationship between bank efficiency and amplified managerial power. According to the study, there should be a separation between the top person of a bank and the top person of the board so that each could monitor the other.

In 2011, Mahmood and Abbas reported a negative correlation between CEO duality and the performance of banks in Pakistan. Therefore, it can be argued that the performance metrics are more negative when firms shift away from dual structures.

2.4 Palestine Code of Corporate Governance Principles

To draft the corporate governance principles in Palestine, the National Committee for Corporate Governance was formed consisting of representatives of regulators, economic, legal, and academic bodies. The committee decided to form a technical team to work on drafting the Palestine Codeof Corporate Governance Principle. The goal of this technical team was to draft the Palestine Code of Corporate Governance incompliance with circumstances and legislations existing in Palestine, taking into account the stable principles in the field of corporate governance (Palestine Code of Corporate Governance, 2009).

The code of corporate governance in Palestine is divided into six aspects: (1) general assembly meetings, (2) equitable shareholders rights, (3) board of directors and executive management, (4) auditing, (5) disclosure and transparency, and (6) other stakeholders. The most important principles under each of these aspects are briefly outlined below (Palestine Code of Corporate Governance Principles, 2009).

General Assembly Meetings

A. The company should send out the notice of general assembly meeting 14 days in advance.

B. The invitation to the general assembly meeting should clearly stipulate the right of shareholders who own in aggregate 10% or more to add items on the agenda of the general assembly meeting.

C. The company should make every effort to make the general assembly meetings easy to attend for all shareholders alike.

D. The board chairman should provide an environment conducive for discussion and questions and answers in general assembly meetings.

E. The board chairman should ensure that the shareholders vote on issues raised in general assembly meetings through a secret ballot per issue.

Equitable Shareholders Rights

The board should ensure that all shareholders, including minority shareholders and shareholders residing outside Palestine, are entitled to all rights vested to them by applicable laws, rules, and regulations and by the code of corporate governance and company's bylaws. These rights are:

A. The right to provide records of ownership.

B. The right to be invited to ordinary and extraordinary general assembly meetings and to be given access to information in accordance with bylaws.

C. The right to fair treatment of all shareholders and the right to enjoy the same rights without bearing any burdens or costs as per the company's bylaws.

D. The right to have a share of the company's cash and in-kind profits.

E. The right to sell, transfer or mortgage shares.

F. The right to vote on suggested company’s profit distribution in the general assembly meeting.

G. The right to elect the members of the board in the general assembly meeting.

H. The right of nomination to the board membership.

I. The right to elect the company's external auditor in the general assembly meeting.

J. The preemptive right at the time of issuance of new shares.

K. The right to participate in the public offer.

L. The right of protection for minority shareholders in cases of company's merger or disposal of one of its main assets.

Board of Directors and Executive Management

A. The company should provide the right for minority shareholders who hold 10% of the company shares to elect a representative on the board.

B. The company should not renew board membership for the same person for more than three consecutive terms.

C. The board should form in particular the following committees: (1) audit committee, (2) remuneration committee, and (3) governance committee.

D. The company should use cumulative voting in order to choose board nominees by giving each shareholder a number of votes equal to his total shares multiplied by the number of board members.

E. The company should have two independent members in the board.

F. The chairman or any board member should not exercise executive functions in the company.

G. Conflict of interest information relating to appointment of directors, senior management and transactions with stakeholders should be published and disclosed.

H. Appointment of board members should be based on a well-defined and transparent nomination process.

I. The company should clearly stipulate the responsibility of board members towards shareholders and stakeholders and grant shareholders/stakeholders the right for restitution in the event of negligence.

Auditing

A. The board should have a clear compliance policy and risk management strategy.

B. The company should establish internal audit and compliance functions.

C. The board should have an audit committee.

D. The competencies, duties and responsibilities of the audit committee should be clearly defined.

E. The head of internal audit should be independent, with direct reporting lines to the board's audit committee.

F. The internal audit team should meet at least once a year with the external auditor and without the presence of management.

G. The external auditor should attend the general assembly meetings during which financial statements are considered to answer shareholder questions.

H. The company should rotate its external auditor (or at least audit partner) at least every five years and should have guidelines for non-audit work.

I. The company should have clearly documented and up-to-date policies relating to HR, IT and financial management.

J. The company should have a sound framework for internal control and risk management and should review and test its effectiveness on an annual basis.

K. The company's financial management function should have adequate staff with professional skills and have modern financial management systems and processes to ensure sound control.

L. The internal audit team should have a clear work plan that is approved.

M. The internal audit team should prepare quarterly and annual reports to the audit committee.

N. The audit committee should review the performance of the internal audit team.

Disclosure and Transparency

A. The company should have a policy to disclose information objectively.

B. The company should have a policy for disclosure of related-party transactions such as loans or services to board members, employees or employees' family.

C. The company should disclose its financial statements and external audit reports.

D. The company should follow and disclose its dividend policy.

E. The company should disclose information relating to development plans, company goals, relevant events, major transactions, risks and relevant tangible information on business operations which may impact business in a transparent and timely manner.

F. The company should disclose information about its external auditors and their terms of engagement.

G. The company should utilize its own web-site for publicizing information.

H. The company should disclose relevant information regarding significant shareholders, including significant shares held by board members in other companies.

I. The company should disclose key corporate governance information, indicating how it complies with the Code of Governance.

J. The company should disclose its corporate social responsibility policies at least annually.

<u>Other Stakeholders</u>

A. The company should set an appropriate mechanism to enable it to treat other stakeholders equally and without discrimination due to race, sex, or religion.

B. Executive management should seta clear financial and managerial system and present it to the board for approval. The corporate governance committee should ensure that the employment system and management comply with applicable rules and regulations and also respect the interests of all stakeholders.

C. The company should inform all its employees of all the procedures set to enable them to choose their representatives, or to grant them the incentives, or provide health insurance, or retirement plans, or annual bonuses. The company should also put a disciplinary system and inform its employees of this system.

D. The board should review the relationships between the company and the stakeholders at least in one of the meetings during the year.

E. The board should put in place a professional ethics code to be approved by the shareholders in the annual general assembly meeting and should be distributed to the staff. The board should make sure that all the activities of the company comply with the approved professional ethics code.

2.5 Application of Corporate Governance in Palestine

In this section, the application of corporate governance principles in Palestine is briefly discussed. This discussion depends on the Baseline Assessment of Corporate Governance in Listed Companies which was issued by the Palestine Governance Institute in 2012 (www.hawkama.ps).

General Assembly Meetings

A. All public shareholding companies hold at least one general assembly meeting per year.

B. Almost all non-bank companies hold their general assembly meetings within four months from year-end. In some cases, general assembly meetings are not held within the deadline for several reasons. The most important of these reasons is the delay in finalizing the audited financial statements. In the case of banks, the Palestine Monetary Authority (PMA) may allow an extended period of time to complete the audited financial statements in their final form.

C. All public shareholding companies include detailed agendas in the invitation to the general assembly meetings.

D. Around 97% of public shareholding companies send out annual reports to shareholders prior to the general assembly meetings.

E. 39% of public shareholding companies hold their general assembly meetings on an official holiday whereas the remaining 61% don't hold their general assembly meetings on an official holiday.

F. 94% of public shareholding companies conduct voting by raising hands and only 6% through secret ballot.

G. The vast majority of public shareholding companies hold their general assembly meetings in Palestine, but some are held abroad.

Board of Directors

A. 64% of public shareholding companies conduct at least six board meetings per year, whereas the rest of them meet less often.

B. 66% of public shareholding companies have some board members who have stayed on the board for more than three terms.

C. Minority shareholders are not represented in most of public shareholding companies' boards.

D. Only 6% of public shareholding companies have independent members in their board.

E. 36% of public shareholding companies have CEOs who are at the same time board members (CEO duality).

F. 63% of public shareholding companies have board chairmen who reside in Palestine.

G. 19% of public shareholding companies have one or more board members who serve on other boards in similar business.

H. 80% of public shareholding companies have clear separation in mandate between boards and executive management whereas the remaining 20% have no such separation.

I. Nearly all public shareholding companies have no formal means for evaluating the performance of their boards.

Auditing

A. Slightly less than half of the public shareholding companies (47%) have audit committees whereas the remaining companies don't have audit committees.

B. 72% of public shareholding companies employ internal auditors whereas the remaining companies don't employ internal auditors.

C. Nearly two-thirds of public shareholding companies (68%) have their internal auditors appointed by the board. On the other hand, about one-third of these companies have their internal auditors hired by general managers.

D. Internal auditors have clearly defined duties and responsibilities in 60% of public shareholding companies.

E. 81% of internal auditors in public shareholding companies have full-time duties.

F. Internal auditors in 60% of public shareholding companies review and evaluate the level of compliance with applicable rules, laws, and regulations.

G. 52% of internal auditors in public shareholding companies issue their internal audit reports annually. By contrast, 40% of internal auditors in these companies issue their internal audit reports on an ad hoc basis, mainly when they feel that they have something worthwhile to report to top management.

H. External auditors are appointed by the general assembly in 94% of public shareholding companies.

I. 81% of public shareholding companies stay with the same external auditor for four years or less. Nearly one-fifth of these companies, on the other hand, stay with the same external auditor for a longer period of time.

J. 59% of public shareholding companies' external auditors make comments on the effectiveness of internal audit practices, whereas 41% of them don't do so.

Disclosure and Transparency

A. 90% of public shareholding companies disclose ownership of shares by board members and first-degree relatives.

B. Nearly all public shareholding companies disclose in their annual reports the salaries and other forms of remuneration to board members and senior executives on an aggregate basis. On the other hand, only 15% of them publish this information on a detailed individual basis.

C. 94% of public shareholding companies disclose financial reports to Palestine Exchange (PEX) within prescribed deadlines.

D. All public shareholding companies prepare their financial reports according to the International Financial Reporting Standards (IFRS).

E. Only 29% of public shareholding companies have social responsibility plans whereas the remaining 71% of these companies don't have such plans.

2.6 Corporate Governance Code for Banks in Palestine

The Palestine Monetary Authority (PMA) has drafted a Corporate Governance Code for Banks to ensure that banks adopt and implement sound corporate governance practices and therefore maintain public trust and confidence in the Palestinian banking sector. The Code has been set at high standards, consistent with the international best practices. It is based on the OECD principles of 2004, Basel Committee on Banking Supervision's paper on enhancing corporate governance for banking organizations that introduced eight principles for sound corporate governance practices for banks, the core principles for effective banking supervision of October 2006 and the subsequent methodology, and is consistent with existing relevant laws and regulations (Corporate Governance Code for Banks in Palestine, 2014).

The Code contains two sets of rules:(1) instructions, and (2) guidelines. The instructions, representing the hard code, are drawn up from the Banking Law No. (2) of 2002 and its explanatory instructions and are supplemented with guidelines or a soft code that represent complementary good governance practices. Banks are required to comply with the instructions laid down in the Code, while they will be subject to the 'comply or explain' approach with regard to the guidelines. However, it is possible that the guidelines will turn into instructions in the future(Corporate Governance Code for Banks in Palestine, 2009).

These rules are classified into nine principles formulated to cover the most important areas that, when appropriately applied, could ensure the proper functioning of the banking sector. These principles are related to(Corporate Governance Code for Banks in Palestine, 2009):

1. Composition of the board of directors.
2. Structure and role of the board of directors.
3. Compliance, internal and external audit functions.
4. Disclosure and transparency.
5. Risk management.
6. Remunerations.
7. Rights and responsibilities of shareholders.
8. Rights and responsibilities of other stakeholders.
9. Code of conduct and ethics.

2.7 The OECD Principles of Corporate Governance

The OECD Principles of Corporate Governance were originally developed in response to a call by the OECD Council Meeting at Ministerial level on 27-28 April 1998, to develop, in conjunction with national governments, other relevant international organizations and the private sector, a set of corporate governance standards and guidelines (OECD Principles of Corporate Governance, 2008).

Since the principles were agreed in 1999, they have formed the basis for corporate governance initiatives in both OECD and non-OECD countries alike. Moreover, they have been adopted as one of the Twelve Key Standards for Sound Financial Systems by the Financial Stability Forum. Accordingly, they form the basis of the corporate governance component of the World Bank/IMF Reports on the Observance of Standards and Codes (OECD Principles of Corporate Governance, 2008).

The principles are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The principles focus on publicly traded companies, both financial and non-financial. However, to the extent they are deemed applicable, they might also be a useful tool to improve corporate governance in non-traded companies, for example, privately held and state-owned enterprises (OECD Principles of Corporate Governance, 2008).

The principles represent a common basis that OECD member countries consider essential for the development of good governance practices. They are intended to be concise, understandable and accessible to the international community. They are not intended to substitute for government, semi-government or private sector initiatives to develop more detailed "best practice" in corporate governance (OECD Principles of Corporate Governance, 2008).

Corporate governance indices (CGIs) emerged in Germany in the late 1991 as government-owned companies were privatized, blue-chip companies experienced serious failures, and young companies needed equity capital. In 2000, the index came out as one solution for investors and analysts who sought a tool to assess the quality of a company's governance, which would guide them in their investment decisions. Since then, the tool has been adopted in many emerging markets and developing countries (Jordan Scorecard of Corporate Governance Standards for Joint Stock Companies, 2011).

CGIs assist boards, investors, financial analysts, regulators, and other stakeholders to systematically assess the level of corporate governance that individual companies have achieved (Jordan Scorecard of Corporate Governance Standards for Joint Stock Companies, 2011).

The OECD principles cover the following areas (OECD Principles of Corporate Governance, 2015):

1. Ensuring the basis for an effective corporate governance framework.
2. The rights of and equitable treatment of shareholders and key ownership functions.
3. Institutional investors, stock markets, and other intermediaries.
4. The role of stakeholders in corporate governance.
5. Disclosure and transparency.
6. The responsibilities of the board.

Each of the above principles is summarized below.

Principle 1:

Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement.

Principle 2:

The Rights and Equitable Treatments of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Principle 3:

Institutional Investors, Stock Markets, and Other Intermediaries

The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.

Principle 4:

The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Principle 5:

Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

Principle 6:

The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

2.8 Basel Corporate Governance Principles for Banks

In this section, the 13 corporate governance principles for banks, set by the Basel Committee on Banking Supervision, are discussed.

The Basel Committee's guidance draws from principles of corporate governance published by the Organization for Economic Cooperation and Development (OECD). The OECD's widely accepted and long-established principles aim to assist governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for participants and regulators of financial markets (Guidelines on Corporate Governance Principles for Banks, 2015).

The Basel Committee's October 2010 principles for enhancing corporate governance represented a consistent development in the Committee's long-standing efforts to promote sound corporate governance practices for banking organizations. The 2010 principles sought to reflect key lessons from the global financial crisis that began in 2007, and enhance how banks govern themselves and how supervisors oversee this critical area (Guidelines on Corporate Governance Principles for Banks, 2015).

Since 2010, the Basel Committee and its member jurisdictions have witnessed banks strengthening their overall governance practices and supervisors enhancing their oversight processes (Guidelines on Corporate Governance Principles for Banks, 2015).

In general, banks exhibit a better understanding of the important elements of corporate governance such as effective board oversight, rigorous risk management, strong internal controls, compliance and other related areas. In addition, many banks have made progress in assessing collective board skills and qualifications, instituting standalone board risk committees, establishing and elevating the role of chief risk officer (CRO), and integrating discussions between board audit and risk committees (Guidelines on Corporate Governance Principles for Banks, 2015).

National authorities have taken measures to improve regulatory and supervisory oversight of corporate and risk governance at banks. These measures include developing or strengthening existing regulation or guidance, raising supervisory expectations for the risk management function, engaging more frequently with the board and management, and assessing the accuracy and usefulness of the information provided to the board (Guidelines on Corporate Governance Principles for Banks, 2015).

In order to assess the progress of national authorities and the banking industry in the area of risk governance since the global financial crisis, the Financial Stability Board (FSB) issued a thematic review on risk governance in February 2013 as part of its series of peer reviews. The peer review found that financial institutions and national authorities have taken measures to improve risk governance. However, more work is needed by both national authorities and banks to establish effective risk governance frameworks and to enumerate expectations for third-party reviews of the framework. Banks also need to enhance the authority and independence of CROs. National authorities need to strengthen their ability to assess the effectiveness of a bank's risk governance and its risk culture and should engage more frequently with the board and its risk and audit committees (Guidelines on Corporate Governance Principles for Banks, 2015).

In the light of ongoing developments in corporate governance, and to take account of the FSB peer review recommendations and other recent papers addressing corporate governance issues, the Basel Committee has decided to revisit the 2010 guidance (Guidelines on Corporate Governance Principles for Banks, 2015).

In July, 2015, the Basel Committee on Banking Supervision issued revised guidelines on corporate governance principles for banks. The 2015 Principles update the Basel Committee's 2010 principles for promoting sound corporate governance practices at banking organizations (Guidelines on Corporate Governance Principles for Banks, 2015).

The 2015 Principles (1) expand the responsibilities of boards of directors, particularly with respect to overseeing the implementation of effective risk management systems, (2) further define the elements of a robust risk governance framework, including with respect to the responsibilities of business units, risk management teams and internal audit, (3) provide guidance for bank supervisors in evaluating the processes used by banking organizations to select board members and senior management and (4) review appropriate compensation structures that convey acceptable risk-taking behavior and reinforce sound risk culture (Guidelines on Corporate Governance Principles for Banks, 2015).

The Principles are summarized below (Guidelines on Corporate Governance Principles for Banks, 2015).

Principle 1:

Board's Overall Responsibilities

The board has overall responsibility for the bank, including approving and overseeing management's implementation of the bank's strategic objectives, governance framework and corporate culture.

Principle 2:

Board Qualification and Composition

Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.

Principle 3:

Board's Own Structure and Practices

The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

Principle 4:

Senior Management

Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.

Principle 5:

Governance of Group Structures

In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring the establishment and operation of a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank group's organizational structure and the risks that it poses.

Principle 6:

Risk Management Function

Banks should have an effective and independent risk management function, under the direction of a chief risk officer, with sufficient stature, independence, resources and access to the board.

Principle 7:

Risk Identification, Monitoring and Controlling.

Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.

Principle 8:

Risk Communication

An effective risk governance framework requires robust communication within the bank about risk, both across the organization and through reporting to the board and senior management.

Principle 9:

Compliance

The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should establish a compliance function and approve the bank's policies and processes for identifying, assessing, monitoring and reporting and advising on compliance risk.

Principle 10:

Internal Audit

The internal audit function should provide independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank.

Principle 11:

Compensation

The bank's remuneration structure should support sound corporate governance and risk management.

Principle 12:

Disclosure and Transparency

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

Principle 13:

The Role of Supervisors

Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

CHAPTER THREE
METHODOLOGY

3.1 Population and Sample

The target population of the study consists of all banks that are licensed by the Palestine Monetary Authority (PMA) to operate in Palestine. On the other hand, the sample of the study consists of the seven Palestinian banks that are listed on Palestine Exchange (PEX). The sample covers the period from (2007) to (2014).The study sample includes the following Palestinian banks which are listed on Palestine Exchange:

1. Bank of Palestine (BOP).
2. Arab Islamic Bank (AIB).
3. Palestine Islamic Bank (ISBK).
4. Palestine Investment Bank (PIBC).
5. Al Quds Bank (QUDS).
6. The National Bank (TNB).
7. Palestine Commercial Bank (PCB).

3.2 Data Sources

In order to answer the questions of the study and thus achieve its objectives, data are collected from secondary sources. Specifically, the data used for this study are obtained using content analysis from the published annual reports of the Palestinian banks listedon Palestine exchange for the eight years period from (2007) to (2014).

3.3 Unit of Analysis

Variables can generally be inferred from the unit of analysis. The unit of analysis is the major entity that is analyzed in the study. For instance, individuals, groups, and firms could be a unit of analysis in a study.

In this study, each bank is considered as a separate unit of analysis. In other words, data are analyzed at the level of banks.

3.4 Measurement of Variables

The dependent variable in this study is the financial performance of banks. This variable is measured by return on assets (ROA) and return on equity (ROE) and the independent variable is corporate governance.

Return on assets (ROA) equals after tax net income divided by average total assets of a bank. This aims to examine the amount of after tax net income that can be earned for every dollar of assets in the bank. This ratio reflects whether the bank uses assets effectively in order to produce its income, so it is an important profitability indicator.

Return on equity (ROE) equals after tax net income divided by average total equity of a bank. This aims to examine the amount of after tax net income that can be earned for every dollar of equity. It indicates the amount of income that shareholders will earn in a bank.

Corporate governance application could be measured using two different approaches. The first approach uses a corporate governance index. The second approach uses proxies to measure corporate governance practices.

In this study, the second approach is used. Specifically, five independent variables are used as proxies to corporate governance practices. These variables are board size, board meeting frequency, board committees, CEO status, and ownership structure.

This approach is adopted for two main reasons. The first reason is that there is no generally accepted corporate governance index in Palestine. The second reason is restrictions imposed by availability of and accessibility to data.

The variables are defined as follows:

Board Size: is the total of board members of a bank.

Board Meeting Frequency: is the total number of board meetings per year.

Board Committees: are the total number of committees in the board.

To investigate the impact of **CEO Status** on bank performance, a dummy variable is used. Specifically, CEO status is 0 if the CEO is not a board member and 1 if the CEO is also a board member. Finally,

Ownership Structure: is measured by the total number of shareholders in the bank.

Organizational characteristics influence the corporate governance structure and, thus, have potential effects on how corporate governance impacts performance (Markarian & Parbonetti, 2007). Therefore, control variables are used in order to control for bank characteristics. These control variables are bank type, bank size, bank experience, and financial leverage.

Bank Type is measured using a dummy variable that takes the value of 0 if the bank is commercial and 1 if the bank is Islamic. **Bank Size** is measured as the natural log of total assets. **Bank Experience** is measured using bank age as a proxy. **Financial Leverage** is measured using debt/asset ratio.

CHAPTER FOUR
DATA ANALYSIS AND INTERPRETATION

4.1 Descriptive Analysis

As mentioned before, return on assets (ROA) and return on equity (ROE) are used as proxies to measure the financial performance of banks.

Table (4.1)shows the descriptive statistics for these variables.

Table 4.1

Descriptive Statistics for Banks Performance Variables

Variable	Minimum	Maximum	Std. Deviation	Mean
Return on assets (ROA)	-3.25	2.43	0.98	0.81
Return on equity (ROE)	-13.59	22.81	6.91	6.06

Source: Researcher's Computation

As indicated in Table (4.1), the mean value of return on assets (ROA) is 0.81% whereas the mean value of return on equity (ROE) is 6.06%.

On the other hand, five variables are used as proxies to measure corporate governance. These variables are board size, board meeting frequency, board committees, CEO status, and ownership structure.

Descriptive statistics for corporate governance variables are shown in Table (4.2).

Table4.2

Descriptive Statistics for Corporate Governance Variables

Variable	Minimum	Maximum	Std. Deviation	Mean
Board size (BS)	6	13	1.42	10.11
Board meeting frequency (BMF)	3	10	1.34	6.39
Board committees (BC)	3	7	0.99	4.05
Ownership structure (OS)	178	16,501	4,628.47	3,243.54

Source: Researcher's Computation

Table (4.2) shows that the average board size is 10 members and ranges from a minimum of 6 members to a maximum of 13 members. Moreover, the average frequency of board meetings in a year is nearly 6 times and ranges between a minimum of 3 times and a maximum of 10 times. The average number of board committees is 4 and ranges from a minimum of 3 and a maximum of 7. Finally, the average number of shareholders is 3,243 and ranges from a minimum of 178 shareholders and a maximum of 16,501 shareholders.

4.2 Hypotheses Testing

Six hypotheses are developed for this study as stated earlier. These hypotheses call for the use of bivariate correlation test (for hypotheses 1, 2, 3 and 5),independent samples t-test (for hypothesis 4), and multiple linear regression (for hypothesis six). The results of these tests and their interpretation are discussed below.

H1:

Board size and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

In order to test the above hypothesis, the bivariate correlation is used. This test is selected since we want to examine the correlation, if any, between two interval variables (board size and bank's financial performance).

As said previously, board size is measured as the total number of members in the board of directors. On the other hand, the financial performance of banks is measured by return on assets (ROA) and return on equity (ROE).

Table (4.3) shows the results of the bivariate correlation between board size and the financial performance of banks as measured by return on assets (ROA).

Table 4.3

Bivariate Correlation between Board Size and ROA

		ROA	Board Size
ROA	Pearson Correlation	1	0.221
	Sig. (2-tailed)		0.109
	N	54	54
Board Size	Pearson Correlation	0.221	1
	Sig. (2-tailed)	0.109	
	N	54	54

Source: Researcher's Computation

Table (4.3) shows that the correlation between board size and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) is 0.221. This coefficient is not high nor statistically significant at the 0.05 level. Thus, the hypothesis that there is a correlation between board size and the financial performance of banks listed on Palestine Exchange is rejected in favor of the alternative hypothesis that there is no significant correlation between these two variables.

Following the same procedure, Table (4.4) shows the results of the bivariate correlation between board size and the financial performance of banks as measured by return on equity (ROE).

<u>Table 4.4</u>

Bivariate Correlation between Board Size and ROE

		ROE	Board Size
ROE	Pearson Correlation	1	0.247
	Sig. (2-tailed)		0.071
	N	54	54
Board Size	Pearson Correlation	0.247	1
	Sig. (2-tailed)	0.071	
	N	54	54

Source: Researcher's Computation

As Table (4.4) indicates, the correlation between board size and bank performance as measured by return on equity (ROA) is 0.247. Again, this correlation coefficient is not numerically high. In addition, the correlation coefficient is not statistically significant at the 0.05 level.

Therefore, the hypothesis that there is a correlation between board size and the financial performance of banks is rejected in favor of the alternative hypothesis that there is no significant correlation between these two variables.

To conclude, there is no significant statistical correlation between board size and the financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA) as well as return on equity (ROE).

H2:

Board meeting frequency and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

The bivariate correlation is selected to test the hypothesis that board meeting frequency and the financial performance of banks listed on Palestine Exchange are correlated. The reason why this test is chosen is that the two variables under consideration (board meeting frequency and bank' financial performance) are both interval.

As said previously, board meeting frequency is measured as the total number of board meetings per year. On the other hand, the financial performance of banks is measured by return on assets (ROA) and return on equity (ROE).

The bivariate correlation between board meeting frequency and financial performance of banks as measured by return on assets (ROA) is conducted using the SPSS. The outcome of the test is shown in Table (4.5).

Table (4.5) shows that the correlation coefficient between board meeting frequency and the financial performance of banks as measured by return on assets (ROA) is 0.491. This coefficient is positive and statistically significant at the 0.01 level. Thus, the hypothesis that there is a correlation between board meeting frequency and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) is accepted.

<u>Table 4.5</u>

Bivariate Correlation between Board Meeting Frequency and ROA

		ROA	Board Meeting Frequency
ROA	Pearson Correlation	1	0.491*
	Sig. (2-tailed)		0.000
	N	54	54
Board Meeting Frequency	Pearson Correlation	0.491*	1
	Sig. (2-tailed)	0.000	
	N	54	54

*Correlation is significant at the 0.01 level (2-tailed)

Source: Researcher's Computation

In other words, board meeting frequency is found to have a positive effect on the financial performance of banks listed on Palestine Exchange. Generally speaking, banks that conduct board meetings more frequently achieve higher financial performance than other banks.

Table (4.6) is the SPSS output of the bivariate correlation between board meeting frequency and the financial performance of banks as measured by return on equity (ROE).

Table (4.6) shows that the correlation coefficient between board meeting frequency and the financial performance of banks listed on Palestine Exchange in terms of return on equity (ROE) equals 0.627. This coefficient is statistically significant at the 0.01 level. The positive sign of the correlation coefficient indicates that board meeting frequency and the financial performance of banks listed on Palestine Exchange are positively correlated.

Table 4.6

Bivariate Correlation between Board Meeting Frequency and ROE

		ROE	Board Meeting Frequency
ROE	Pearson Correlation	1	0.627*
	Sig. (2-tailed)		0.000
	N	54	54
Board Meeting Frequency	Pearson Correlation	0.627*	1
	Sig. (2-tailed)	0.000	
	N	54	54

*Correlation is significant at the 0.01 level (2-tailed)

Source: Researcher's Computation

To conclude, the frequency of board meetings in the banking sector in Palestine is considered to be an important way of improving the effectiveness of the board and thus improving the financial performance. It is generally argued that board meetings are important channels through which board members fulfill their monitoring role.

The above results are consistent with the findings of Ntim and Oser (2011) who conducted a study in South Africa which suggested similar findings between the frequency of board meetings and corporate performance where boards that meet more frequently tend to generate higher financial performance.

H3:

Board committees and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

To test the hypothesis that there is a correlation between board committees and the financial performance of banks listed on Palestine Exchange, the bivariate correlation test is used since both variables are interval.

The outcome of the bivariate correlation between board committees and the financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA) is shown in Table (4.7).

Table 4.7

Bivariate Correlation between Board Committees and ROA

		ROA	Board Committees
ROA	Pearson Correlation	1	0.098
	Sig. (2-tailed)		0.480
	N	54	54
Board Committees	Pearson Correlation	0.098	1
	Sig. (2-tailed)	0.480	
	N	54	54

Source: Researcher's Computation

Table (4.7) shows that the correlation coefficient between board committees and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) is less than 0.10. This coefficient is very low and not statistically significant.

Thus, the hypothesis that there is a correlation between board committees and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) is rejected. Therefore, we can conclude that the number of board committees and the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) are not correlated.

The bivariate correlation between board committees and the financial performance of banks in terms of return on equity is shown in Table (4.8).

Table 4.8

Bivariate Correlation between Board Committees and ROE

		ROE	Board Committees
ROE	Pearson Correlation	1	0.218
	Sig. (2-tailed)		0.114
	N	54	54
Board Committees	Pearson Correlation	0.218	1
	Sig. (2-tailed)	0.114	
	N	54	54

Source: Researcher's Computation

Table (4.8) shows that the correlation coefficient between board committees and the financial performance of banks listed on Palestine Exchange in terms of return on equity (ROE) equals 0.218. This coefficient is not statistically significant at the 0.05 level.

Thus, the hypothesis that there is a correlation between board committees and the financial performance of banks listed on Palestine Exchange as measured by return on equity (ROE) is rejected. As a result, we can conclude that the number of board committees and the financial performance of banks are not related.

H4:

Financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA) and return on equity (ROE) differs according to CEO status.

To test the above hypothesis, the t-test is used. This test is selected since we are interested to compare the means of an interval dependent variable (bank's financial performance) for two independent groups (independent CEO and board member CEO).

As stated earlier, CEO status is measured using a dummy variable that takes the value of 0 if the CEO is independent from the board of directors and 1 if the CEO is also a board member. The results of the t-test done are shown in Tables (4.9) and (4.10).

Table 4.9

Group Statistics for the Independent Samples T-Test (ROA)

	CEO Status	N	Mean	Std. Deviation	Std. Error Mean
ROA	Independent CEO	46	0.6026	0.90174	0.13295
	Board member CEO	8	2.0125	0.25778	0.09114

Source: Researcher's Computation

Table (4.9) indicates that the mean of return on assets (ROA) for banks in Palestine that have independent CEOs is approximately 0.60%. On the other hand, banks in which the CEO is also a board member have a mean value of return on assets (ROA) equal to 2.01%.

These figures indicate that banks that have CEOs who are also board members achieve higher performance than other banks in terms of return on assets (ROA).

To test the above results formally, we look at the significance column under the t-test for equality of means in Table (4.10). The difference in the means of 0.60 and 2.01 for independent CEOs and board member CEOs is significant at the 0.01 level.

As a result, the hypothesis that bank performance in Palestine differs according to CEO status is accepted. Specifically, banks that have independent CEOs tend to have performance worse than other banks in terms of return on assets (ROA).

Table 4.10

Independent Samples T-Test (ROA)

		Levene's Test for Equality of Variances		T-Test for Equality of Means		
		F	Sig.	t	df	Sig.
ROA	Equal variances assumed	2.333	0.133	-4.360	52	0.000
	Equal variances not assumed			-8.747	40.185	0.000

Source: Researcher's Computation

The same test is done again using return on equity (ROE). The results of the t-test are shown in Tables (4.11) and (4.12).

Table 4.11

Group Statistics for the Independent Samples T-Test (ROE)

	CEO Status	N	Mean	Std. Deviation	Std. Error Mean
ROE	Independent CEO	46	3.9933	5.08367	0.74955
	Board member CEO	8	17.9313	2.46052	0.86992

Source: Researcher's Computation

As indicated in Table (4.11), the mean of return on equity (ROE) for banks that have independent CEOs is 3.9%. On the other hand, banks in which the CEO is also a board member have a mean value of return on equity (ROE) equal to 17.9%. Obviously, the figures indicate that banks that have CEOs who are also board members achieve higher performance than other banks in terms of return on equity (ROE).

Table 4.12

Independent Samples T-Test (ROE)

		Levene's Test for Equality of Variances		T-Test for Equality of Means		
		F	Sig.	t	df	Sig.
ROE	Equal variances assumed	2.205	0.144	-7.557	52	0.000
	Equal variances not assumed			-12.138	19.573	0.000

Source: Researcher's Computation

The t-test for equality of means in Table (4.12) indicates that the difference in the means of 3.9 and 17.9 is statistically significant at the 0.01 level. Thus, the hypothesis that bank performance differs according to CEO status is accepted. More specifically, banks in which CEOs are also board members tend to have better performance in terms of return on equity (ROE).

The above findings are consistent with the findings of Al-Hawary (2011) who investigated the effect of governance on the performance of Jordanian commercial banks. He tested the effect of governance mechanisms such as board size, CEO duality, percentage of non-executive directors, capital adequacy, ownership percentage of large shareholders, and ownership percentage of the largest shareholder on the bank performance. He found that CEO duality has statistically significant positive effect on performance.

H5:

Ownership structure and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE) are correlated.

The hypothesis that there is a correlation between ownership structure and the financial performance of banks listed on Palestine Exchange is tested using the bivariate correlation test since both variables are interval in nature.

Table (4.13) shows the outcome of the bivariate correlation between ownership structure and the financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA).

Table (4.13) shows that the correlation coefficient between ownership structure and bank performance in Palestine as measured by return on assets (ROA) is not statistically significant at the 0.05 level.

Table 4.13

Bivariate Correlation between Ownership Structure and ROA

		Bank Performance	Ownership Structure
Bank Performance	Pearson Correlation	1	-0.182
	Sig. (2-tailed)		0.187
	N	54	54
Ownership Structure	Pearson Correlation	-0.182	1
	Sig. (2-tailed)	0.187	
	N	54	54

Source: Researcher's Computation

Thus, the hypothesis that there is a correlation between ownership structure and financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) is rejected. Therefore, it is concluded that ownership structure and the financial performance of banks as measured by return on assets (ROA) are not related.

Using the same procedure, Table (4.14) shows the outcome of the bivariate correlation between ownership structure and the financial performance of banks listed on Palestine Exchange in terms of return on equity (ROE).

Table (4.14) shows that the correlation coefficient between ownership structure and the financial performance of banks listed on Palestine Exchange as measured by return on equity (ROE) is not statistically significant at the 0.05 level.

Thus, the hypothesis that there is a correlation between ownership structure and the financial performance of banks listed on Palestine Exchange as measured by return on equity (ROE) is rejected. Therefore, it is concluded that ownership structure and the financial performance of banks as measured by return on equity (ROE) are not related.

<u>Table 4.14</u>

Bivariate Correlation between Ownership Structure and ROE

		ROE	Ownership Structure
ROE	Pearson Correlation	1	-0.109
	Sig. (2-tailed)		0.431
	N	54	54
Ownership Structure	Pearson Correlation	-0.109	1
	Sig. (2-tailed)	0.431	
	N	54	54

Source: Researcher's Computation

H6:

*Board size, board meeting frequency, board committees, CEO status, and ownership structure will significantly explain the variance in the financial performance of banks listed on Palestine Exchange as measured by return on assets (ROA) and return on equity (ROE)***.**

The multiple linear regression technique is used to test the above hypothesis since we are interested in investigating the effect of the five independent variables (board size, board meeting frequency, board committees, CEO status, and ownership structure) on the dependent variable (financial performance of banks).

Table (4.15) shows the outcome of regressing the five independent variables as well as the control variables on return on assets (ROA).

Table 4.15

Regression Model Using ROA as Dependent Variable

Constant & Variables	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Constant	-5.502	5.092		-1.080	0.286
Board Size	-0.020	0.130	-0.029	-0.153	0.879
Board Meeting Frequency	0.081	0.147	0.111	0.553	0.583
Board Committees	-0.083	0.182	-0.084	-0.455	0.651
CEO Duality	1.468	2.648	0.539	0.554	0.582
Ownership Structure	-6.307E-5	0.000	-0.299	-0.771	0.445
Bank Type	1.689	0.863	0.765	1.957	0.057
Bank Size	0.186	0.289	0.153	0.645	0.522
Bank Experience	-0.019	0.075	-0.265	-0.254	0.801
Financial Leverage	0.036	0.018	0.822	2.034	0.048
R-Square: 0.399					
F-Value: 3.243					

Table (4.15) shows that the overall regression model is significant at the 0.05 level with an F-value of 3.243. This means that the dependent variables as well as the controlling variables jointly explain the variation in return on assets (ROA). The value of R-square of 0.399 means that these variables explain nearly 40% of the variation in return on asset (ROA).

All the corporate governance variables are not statistically significant at the 0.05 level. This means that these variables do not explain the variation in return on asset (ROA). Among the controlling variables, bank type and financial leverage are statistically significant at the 0.05 level.

Since bank type is measured using a dummy variable that takes the value of 0 if the bank is commercial and 1 if the bank is Islamic, the positive coefficient sign of bank type indicates that Islamic banks generate, on average, higher return on asset (ROA) than commercial banks. The positive coefficient sign of financial leverage means that banks with higher financial leverage generate, on average, higher return on asset (ROA)

Using the same procedure, Table (4.16) shows the outcome of regressing the five independent variables as well as the control variables on return on equity (ROE).

Table (4.16) shows that the overall regression model is statistically significant at the 0.05 level. This means that all the independent variables as well as the controlling variables together explain the variation in the dependent variable (return on equity). The R-square value of 0.663 indicates that nearly 66% of the variation in return on equity (ROE) can be explained by the variables entered into the regression.

The t values of independent variables indicate that all the corporate governance variables are not statistically significant at the 0.05 level. This means that the corporate governance variables that are included in the model do not explain the financial performance of banks listed on Palestine Exchange in terms of return on equity (ROE).

On the other hand, two of the controlling variables are statistically significant at the 0.05 level. Specifically, bank type and financial leverage are significant at the 0.05 level. The positive sign of bank type coefficient means that Islamic banks generate, on average, higher return on equity (ROE) than commercial banks since bank type is measured using a dummy variable with a value of 0 is the bank is commercial and 1 if the bank is Islamic.

<u>Table 4.16</u>

Regression Model Using ROE as Dependent Variable

Constant & Variables	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Constant	-63.763	26.989		-2.363	0.023
Board Size	0.217	0.689	0.045	0.315	0.754
Board Meeting Frequency	0.339	0.779	0.066	0.435	0.666
Board Committees	-0.215	0.963	-0.031	-0.223	0.824
CEO Duality	13.339	14.035	0.692	0.950	0.347
Ownership Structure	0.000	0.000	-0.188	-0.648	0.520
Bank Type	12.291	4.575	0.786	2.687	0.010
Bank Size	2.445	1.532	0.283	1.596	0.118
Bank Experience	-0.148	0.396	-0.293	-0.375	0.710
Financial Leverage	0.234	0.093	0.759	2.507	0.016
R-Square: 0.663					
F-Value:9.614					

CHAPTER FIVE
CONCLOSIONS, RECOMMENDATIONS, AND IMPLICATIONS

The study examined the impact of corporate governance on banks financial performance in Palestine using eight years data from 2007 to 2014. Corporate governance is measured using board size, board meeting frequency, board committees, CEO status, and ownership structure. Meanwhile, return on assets (ROA)and return on equity (ROE) are used as a measure of bank financial performance. The bivariate correlation test as well as the t-test are used to test the developed hypotheses. This section highlights the main conclusions and presents the key recommendations of the study.

5.1 Conclusions

The main conclusions of the study are presented below:

1. Board size and financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA)and return on equity (ROE) are not correlated.

   The Palestine Code of Corporate Governance Principles sets forth a number of characteristics for board of directors. First of all, the number of board members should be 5-11.Second, the board term should not exceed 4 years and it should come to an end when a new board is elected.

   Third, it is preferable that the board reflects the composition of the shareholders and the distribution of capital. Minority shareholders holding collectively 10% or more of the company's shares may elect their representative in the board.

Fourth, it is preferable that amongst the board members there are two independent members. An independent board member means that the board member has no other relation with the company other than his or her membership in the board.

Finally, it is preferable that the board members enjoy leadership skills. In addition, the members should have diverse experience and skills that fit the nature of the company in a way to ensure that the board fulfills its duties objectively and efficiently. It is also preferable that board members get training to ensure their efficient participation in company's work.

The researcher believes that complying with board membership requirements mentioned in the Code would enhance the efficiency of boards in a way that would lead to better financial performance of banks in Palestine.

2. Board meeting frequency and financial performance of banks listed on Palestine Exchange in terms of both return on assets (ROA) and return on equity (ROE) are positively correlated. This means that boards that meet more frequently tend to generate higher performance.

The Company's Law requires public shareholding companies to hold at least 6 board meetings per year. The majority of listed public shareholding companies (64%) committed to hold six board meetings per year, according to the Company's Law and the Code (Palestine Governance Institute, 2012)

The researcher believes complying with the Company's Law and the Code regarding the frequency of board meeting would enhance the monitoring role of boards in a way that would lead to better financial performance.

3. Number of board committees and financial performance of banks listed on Palestine Exchange in terms of return on assets (ROA) and return on equity (ROE) are not related.

The Palestine Code of Corporate Governance Principles states that it is preferable that the by-law of the company includes precise definition of the responsibilities of the board, its members, and its committees.

Also, the board has the right to form permanent or temporary committees of its members and assign to them specific tasks. It is preferable in this respect to renew the membership of these committees in order to help the board fulfill its duties in a specialized and precise way.

Furthermore, it is preferable that the board forms in particular the following committees: (1) audit committee, (2) remuneration committee, and (3) governance committee.

The researcher believes that the conclusion of no significant relationship between the number of board committees and bank performance may be due to non-compliance with the above requirements regarding board committees.

4. Bank performance in Palestine differs, in general, according to CEO status. The results indicate that banks that have CEOs who are also board members achieve higher performance in terms of both return on assets (ROA) and return on equity (ROE) than other banks.

   The Palestine Code of Corporate Governance states that it is preferable that the chairman of the board or any board member does not practice executive functions in the company or give the impression that he or she does in order to maintain the distribution of authority and responsibility rather than having it centralized in one person's hand. This is also better for accountability reasons since the board chairman cannot question himself.

   The researcher believes that banks with CEO duality achieve higher performance could be explained by two facts: (1)CEO duality creates more efficient communication between the board and executive management and (2) most companies in Palestine are characterized as family companies where there is no clear separation between management and ownership.

5. There is no significant relationship between ownership structure and bank performance in Palestine in terms of return on assets (ROA) and return on equity (ROE).

   The researcher believes that ownership structure of banks does not have a significant effect on banks financial performance since in most banks dominant shareholders have considerable powers. On the other hand, minority shareholders in most banks have no representative in the board of directors.

5.2 Recommendations

The following key recommendations can be made in light of the findings of the study:

Regulators:

1. Corporate governance principles must be compulsory, instead of voluntary, in all developing countries, including Palestine.
2. Regulators should take steps to make the code of corporate governance principles compulsory for all listed companies, including banks. In addition, continuous review of the code should be done.
3. Regulators must take the necessary measures to separate the roles of CEO and board membership in public shareholding companies in general and banks in particular.
4. Regulators must take the necessary measures to impose the international standard of a minimum number of independent members in the board of directors so that the independent directors can perform the duty of evaluation and monitoring of management in an objective way.

Banks:

5. Keeping the members of a bank board to a minimum size is recommended since that minimum size enables the board to perform its supervision activities properly.

Moreover, a bank board must be made up of qualified professionals who are familiar with oversight function.

6. Continuous training should be given to board members and senior managers in banks to promote corporate governance practices.

Investors:

7. Investors are advised to know the corporate governance characteristics of banks in Palestine before investing in any of them.

Researchers:

8. Researchers are recommended to conduct further studies that take into consideration sectors in the Palestine Exchange (PEX) other than the banking sector such asthe manufacturing, insurance, investment, and service sectors.
9. Researchers are recommended to conduct further studies that take into consideration variables that are not dealt with in this study.
10. Future research should focus on assessing the impact of corporate governance on bank performance from the perspective of different stakeholders such as employees, management, shareholders and depositors.

5.3 Policy Implications

Empirical findings reveal that as a mean to strengthen the performance of banks in Palestine, the Palestine Monetary Authority (PMA) and the Palestine Capital Market

Authority (PCMA) should be concerned about the level of corporate governance mechanisms of banks.

The findings also suggest that shareholders should actively take part in establishing good corporate governance in the banks they own in order to earn better and sustainable profits. The PMA as well as the PCMA should encourage banks to implement good corporate governance practices through enacting rules and regulations. Keeping the number of members in a bank board to a minimum size is recommended, so long as that minimum size enables the board to perform its supervision activities properly.

Finally, future research should focus on assessing the impact of corporate governance on firm performance from the perspective of different stakeholders such as employees, management, shareholders and depositors of banks.

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APPENDIX A
THE HISTORY OF CORPORATE GOVERNANCE

1600s: The East India Company introduces a Court of Directors, separating ownership and control (U.K., the Netherlands).

1776: Adam Smith in the "Wealth of Nations" warns of weak controls over and incentives for management (U.K.).

1844: First Joint Stock Company Act (U.K.).

1931: Berle and Means publishes its seminal work "The Modern Corporation and Private Property" (U.S.).

1933/34: The Securities Act of 1933 is the first act to regulate the securities markets, notably registration disclosure. The 1934 Act delegates responsibility for enforcement to the SEC (U.S.).

1968: The EU adopts its first company law directive (EU).

1987: The Tread way Commission reports on fraudulent financial reporting, confirming the role and status of audit committees and develops a framework for internal control, or COSO, published in 1992 (U.S.).

Early 1990s: Polly Peck (£1.3 billion in losses), BCCI and Maxwell (£480 million) business empires collapse, calling for improved corporate governance practices to protect investors (U.K.).

1992: The Cadbury Committee publishes the first code on corporate governance and in 1993, companies listed on the U.K.'s stock exchanges are required to disclose governance on a "comply or explain" basis (U.K.).

1994: Publication of the King Report (S. Africa).

1994, 1995: Rutteman (on Internal Controls and Financial Reporting), Greenbury (on Executive Remuneration), and Hampel (on Corporate Governance) reports are published (U.K.).

1995: Publication of the Vienot Report (France).

1996: Publication of the Peters Report (the Netherlands).

1998: Publication of the Combined Code (U.K.).

1999: OECD publishes the first international benchmark, the OECD Principles of Corporate Governance.

1999: Publication of the Turnbull guidance on internal controls (U.K.).

2001: Enron Corporation, then the seventh largest listed company in the U.S., declares bankruptcy (U.S.).

2001: 2001: The Lamfalussy Report on the Regulation of European Securities Markets (EU) is published.

2002: Publication of the German Corporate Governance Code (Germany).

2002: The Enron collapse and other corporate scandals lead to the Sarbanes-Oxley Act (U.S.); the Winter Report on company law reform in Europe is published (EU).

2003: The Higgs Report on non-executive directors is published (U.K.).

2004: The Parmalat scandal shakes Italy, with possible EU-wide repercussions (EU).

APPENDIX B
THE OECD PRINCIPLES OF CORPORATE GOVERNANCE

Principle 1:

Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement.

Effective corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations. This corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. The desirable mix between legislation, regulation, self-regulation, voluntary standards, etc., will therefore vary from country to country. The legislative and regulatory elements of the corporate governance framework can usefully be complemented by soft law elements based on the "comply or explain" principle such as corporate governance codes in order to allow for flexibility and address specificities of individual companies. What works well in one company, for one investor or a particular stakeholder may not necessarily be generally applicable to corporations, investors and stakeholders that operate in another context and under different circumstances. As new experiences accrue and business circumstances change, the different provisions of the corporate governance framework should be reviewed and, when necessary, adjusted.

Countries seeking to implement the Principles should monitor their corporate governance framework, including regulatory and listing requirements and business practices, with the objective of maintaining and strengthening its contribution to market integrity and economic performance. As part of this, it is important to take into account the interactions and complementarily between different elements of the corporate governance framework and its overall ability to promote ethical, responsible and transparent corporate governance practices. Such analysis should be viewed as an important tool in the process of developing an effective corporate governance framework. To this end, effective and continuous consultation with the public is an essential element. In some jurisdictions, this may need to be complemented by initiatives to inform companies and their stakeholders about the benefits of implementing sound corporate governance practices. Moreover, in developing a corporate governance framework in each jurisdiction, national legislators and regulators should duly consider the need for, and the results from, effective international dialogue and co-operation. If these conditions are met, the corporate governance framework is more likely to avoid over-regulation, support the exercise of entrepreneurship and limit the risks of damaging conflicts of interest in both the private sector and in public institutions.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets.

The corporate form of organization of economic activity is a powerful force for growth. The regulatory and legal environment within which corporations operate is therefore of key importance to overall economic outcomes. Policymakers also have a responsibility to put in place a framework that is flexible enough to meet the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources. Where appropriate, corporate governance frameworks should therefore allow for proportionality, in particular with respect to the size of listed companies. Other factors that may call for flexibility include the company's ownership and control structure, geographical presence, sectors of activity, and the company's stage of development. Policy makers should remain focused on ultimate economic outcomes and when considering policy options, they will need to undertake an analysis of the impact on key variables that affect the functioning of markets, for example in terms of incentive structures, the efficiency of self-regulatory systems and dealing with systemic conflicts of interest. Transparent and well-functioning markets serve to discipline market participants and to promote accountability.

B. The legal and regulatory requirements that affect corporate governance practices should be consistent with the rule of law, transparent and enforceable.

If new laws and regulations are needed, such as to deal with clear cases of market imperfections, they should be designed in a way that makes them possible to implement and enforce in an efficient and even handed manner covering all parties. Consultation by government and other regulatory authorities with corporations, their representative organizations and other stakeholders, is an effective way of doing this. Mechanisms should also be established for parties to protect their rights. In order to avoid over-regulation, unenforceable laws, and unintended consequences that may impede or distort business dynamics, policy measures should be designed with a view to their overall costs and benefits.

Public authorities should have effective enforcement and sanctioning powers to deter dishonest behavior and provide for sound corporate governance practices. In addition, enforcement can also be pursued through private action, and the effective balance between public and private enforcement will vary depending upon the specific features of each jurisdiction.

Corporate governance objectives are also formulated in voluntary codes and standards that do not have the status of law or regulation. While such codes play an important role in improving corporate governance arrangements, they might leave shareholders and other stakeholders with uncertainty concerning their status and implementation. When codes and principles are used as a national standard or as a complement to legal or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.

C. The division of responsibilities among different authorities should be clearly articulated and designed to serve the public interest.

Corporate governance requirements and practices are typically influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, insolvency law, contract law, labor law and tax law. Corporate governance practices of individual companies are also often influenced by human rights and environmental laws. Under these circumstances, there is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives. It is important that policy makers are aware of this risk and take measures to limit it. Effective enforcement also requires that the allocation of responsibilities for supervision, implementation and enforcement among different authorities is clearly defined so that the competencies of complementary bodies and agencies are respected and used most effectively. Potentially conflicting objectives, for example where the same institution is charged with attracting business and sanctioning violations, should be avoided or managed through clear governance provisions. Overlapping and perhaps contradictory regulations between jurisdictions is also an issue that should be monitored so that no regulatory vacuum is allowed to develop (i.e. issues slipping through in which no authority has explicit responsibility) and to minimize the cost of compliance with multiple systems by corporations. When regulatory responsibilities or oversight are delegated to non-public bodies, it is desirable to explicitly assess why, and under what circumstances, such delegation is desirable. In addition, the public authority should maintain effective safeguards to ensure that the delegated authority is applied fairly, consistently, and in accordance with the law. It is also essential that the governance structure of any such delegated institution be transparent and encompass the public interest.

D. Stock market regulation should support effective corporate governance.

Stock markets can play a meaningful role in enhancing corporate governance by establishing and enforcing requirements that promote effective corporate governance by their listed issuers. Also, stock markets provide facilities by which investors can express interest or disinterest in a particular issuer's governance by allowing them to buy or sell the issuer's securities, as appropriate. The quality of the stock market's rules and regulations that establish listing criteria for issuers and that govern trading on its facilities is therefore an important element of the corporate governance framework.

What traditionally were called "stock exchanges" today come in a variety of shapes and forms. Most of the large stock exchanges are now profit maximizing and themselves publicly traded joint stock companies that operate in competition with other profit maximizing stock exchanges and trading venues. Regardless of the particular structure of the stock market, policy makers and regulators should assess the proper role of stock exchanges and trading venues in terms of standard setting, supervision and enforcement of corporate governance rules. This requires an analysis of how the particular business models of stock exchanges affect the incentives and ability to carry out these functions.

E. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

Supervisory, regulatory and enforcement responsibilities should be vested with bodies that are operationally independent and accountable in the exercise of their functions and powers, have adequate powers, proper resources, and the capacity to perform their functions and exercise their powers, including with respect to corporate governance. Many countries have addressed the issue of political independence of the securities supervisor through the creation of a formal governing body (a board, council, or commission) whose members are given fixed terms of appointment. If the appointments are staggered and made independent from the political calendar, they can further enhance independence. These bodies should be able to pursue their functions without conflicts of interest and their decisions should be subject to judicial or administrative review. When the number of corporate events and the volume of disclosures increase, the resources of supervisory, regulatory and enforcement authorities may come under strain. As a result, in order to follow developments, they will have a significant demand for fully qualified staff to provide effective oversight and investigative capacity which will need to be appropriately funded. The ability to attract staff on competitive terms will enhance the quality and independence of supervision and enforcement.

F. Cross-border co-operation should be enhanced, including through bilateral and multilateral arrangements for exchange of information.

High levels of cross-border ownership and trading require strong international co-operation among regulators, including through bilateral and multilateral arrangements for exchange of information. International co-operation is becoming increasingly relevant for corporate governance, notably where companies are active in many jurisdictions through both listed and unlisted entities, and seek multiple stock market listings on exchanges in different jurisdictions.

Principle 2:

The Rights and Equitable Treatment of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including *minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.*

Equity investors have certain property rights. For example, an equity share in a publicly traded company can be bought, sold, or transferred. An equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment. In addition, ownership of an equity share provides a right to information about the corporation and a right to influence the corporation, primarily by participation in general shareholder meetings and by voting.

As a practical matter, however, the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board and a management team that is selected, motivated and, when necessary, replaced by the board.

Shareholders' rights to influence the corporation center on certain fundamental issues, such as the election of board members, or other means of influencing the composition of the board, amendments to the company's organic documents, approval of extraordinary transactions, and other basic issues as specified in company law and internal company statutes. This Section can be seen as a statement of the most basic rights of shareholders, which are recognized by law in most countries. Additional rights such as the approval or election of auditors, direct nomination of board members, the ability to pledge shares, the approval of distributions of profits, shareholder ability to vote on board member and/or key executive compensation, approval of material related party transactions and others have also been established in various jurisdictions.

Investors' confidence that the capital they provide will be protected from misuse or misappropriation by corporate managers, board members or controlling shareholders is an important factor in the development and proper functioning of capital markets. Corporate boards, managers and controlling shareholders may have the opportunity to engage in activities that advance their own interests at the expense of non-controlling shareholders. In providing protection to investors, a distinction can usefully be made between ex ante and ex post shareholder rights. Ex ante rights are, for example, pre-emptive rights and qualified majorities for certain decisions. Ex post rights allow the seeking of redress once rights have been violated. In jurisdictions where the enforcement of the legal and regulatory framework is weak, it can be desirable to strengthen the ex-ante rights of shareholders such as by low share ownership thresholds for placing items on the agenda of the shareholders meeting or by requiring a supermajority of shareholders for certain important decisions. The Principles support equal treatment for foreign and domestic shareholders in corporate governance. They do not address government policies to regulate foreign direct investment.

One of the ways in which shareholders can enforce their rights is to be able to initiate legal and administrative proceedings against management and board members. Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. The provision of such enforcement mechanisms is a key responsibility of legislators and regulators.

There is some risk that a legal system which enables any investor to challenge corporate activity in the courts can become prone to excessive litigation. Thus, many legal systems have introduced provisions to protect management and board members against litigation abuse in the form of tests for the sufficiency of shareholder complaints, so-called safe harbors for management and board member actions (such as the business judgment rule) as well as safe harbors for the disclosure of information. In the end, a balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation. Many countries have found that alternative adjudication procedures, such as administrative hearings or arbitration procedures organized by the securities regulators or other regulatory bodies, are an efficient method for dispute settlement, at least at the first instance level. Specialized court procedures can also be a practical instrument to obtain timely injunctions, and ultimately facilitate the rapid settlement of disputes.

A. Basic shareholder rights should include the right to: (1) secure methods of ownership registration,(2) convey or transfer shares,(3) obtain relevant and material information on the corporation on a timely and regular basis,(4) participate and vote in general shareholder meetings,(5) elect and remove members of the board, and (6) share in the profits of the corporation.

B. Shareholders should be sufficiently informed about, and have the right to approve or participate in, decisions concerning fundamental corporate changes such as: (1) amendments to the statutes, or articles of incorporation or similar governing documents of the company,(2) the authorization of additional shares, and (3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

The ability of companies to form partnerships and related companies and to transfer operational assets, cash flow rights and other rights and obligations to them is important for business flexibility and for delegating accountability in complex organizations. It also allows a company to divest itself of operational assets and to become only a holding company. However, without appropriate checks and balances such possibilities may also be abused.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

2. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

The right to participate in general shareholder meetings is a fundamental shareholder right. Management and controlling investors have at times sought to discourage non-controlling or foreign investors from trying to influence the direction of the company. Some companies have charged fees for voting. Other potential impediments include prohibitions on proxy voting, the requirement of personal attendance at general shareholder meetings to vote, holding the meeting in a remote location, and allowing voting by show of hands only. Still other procedures may make it practically impossible to exercise ownership rights. Voting materials may be sent too close to the time of general shareholder meetings to allow investors adequate time for reflection and consultation. Many companies are seeking to develop better channels of communication and decision-making with shareholders. Efforts by companies to remove artificial barriers to participation in general meetings are encouraged and the corporate governance framework should facilitate the use of electronic voting in absentia, including the electronic distribution of proxy materials and reliable vote confirmation systems. In jurisdictions where private enforcement is weak, regulators should be in a position to curb unfair voting practices.

3. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.

In order to encourage shareholder participation in general meetings, many jurisdictions have improved the ability of shareholders to place items on the agenda through a simple and clear process of filing amendments and resolutions, and to submit questions in advance of the general meeting and to obtain replies from management and board members. Shareholders should also be able to ask questions relating to the external audit report. Companies are justified in assuring that abuses of such opportunities do not occur. It is reasonable, for example, to require that in order for shareholder resolutions to be placed on the agenda, they need to be supported by shareholders holding a specified market value or percentage of shares or voting rights. This threshold should be determined taking into account the degree of ownership concentration, in order to ensure that minority shareholders are not effectively prevented from putting any items on the agenda. Shareholder resolutions that are approved and fall within the competence of the shareholders' meeting should be addressed by the board.

4. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known, including through votes at shareholder meetings, on the remuneration of board members and/or key executives, as applicable. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

   To elect the members of the board is a basic shareholder right. For the election process to be effective, shareholders should be able to participate in the nomination of board members and vote on individual nominees or on different lists of them. To this end, shareholders have access in a number of countries to the company's voting materials which are made available to shareholders, subject to conditions to prevent abuse. With respect to nomination of candidates, boards in many companies have established nomination committees to ensure proper compliance with established nomination procedures and to facilitate and co-ordinate the search for a balanced and qualified board. It is regarded as good practice for independent board members to have a key role on this committee. To further improve the selection process, the Principles also call for full and timely disclosure of the experience and background of candidates for the board and the nomination process, which will allow an informed assessment of the abilities and suitability of each candidate. It is considered good practice to also disclose information about any other board positions that nominees hold, and in some jurisdictions also positions that they are nominated for.

The Principles call for the disclosure of remuneration of board members and key executives. In particular, it is important for shareholders to know the remuneration policy as well as the total value of compensation arrangements made pursuant to this policy. Shareholders also have an interest in how remuneration and company performance are linked when they assess the capability of the board and the qualities they should seek in nominees for the board. The different forms of say-on-pay (binding or advisory vote, ex-ante and/or ex post, board members and/or key executives covered, individual and/or aggregate compensation, compensation policy and/or actual remuneration) play an important role in conveying the strength and tone of shareholder sentiment to the board. In the case of equity-based schemes, their potential to dilute shareholders' capital and to powerfully determine managerial incentives means that they should be approved by shareholders, either for individuals or for the policy of the scheme as a whole. Shareholder approval should also be required for any material changes to existing schemes.

5. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

   The objective of facilitating shareholder participation suggests that jurisdictions and/or companies promote the enlarged use of information technology in voting, including secure electronic voting in all listed companies. The Principles recommend that voting by proxy be generally accepted. Indeed, it is important to the promotion and protection of shareholder rights that investors can place reliance upon directed proxy voting. The corporate governance framework should ensure that proxies are voted in accordance with the direction of the proxy holder. In those jurisdictions where companies are allowed to obtain proxies, it is important to disclose how the Chairperson of the meeting (as the usual recipient of shareholder proxies obtained by the company) will exercise the voting rights attaching to undirected proxies. Where proxies are held by the board or management for company pension funds and for employee stock ownership plans, the directions for voting should be disclosed. It is regarded as good practice that treasury shares and shares of the company held by subsidiaries should not be allowed to vote, nor be counted for quorum purposes.

6. Impediments to cross border voting should be eliminated.

Foreign investors often hold their shares through chains of intermediaries. Shares are typically held in accounts with securities intermediaries, that in turn hold accounts with other intermediaries and central securities depositories in other jurisdictions, while the listed company resides in a third country. Such cross-border chains cause special challenges with respect to determining the entitlement of foreign investors to use their voting rights, and the process of communicating with such investors. In combination with business practices which provide only a very short notice period, shareholders are often left with only very limited time to react to a convening notice by the company and to make informed decisions concerning items for decision. This makes cross border voting difficult. The legal and regulatory framework should clarify who is entitled to control the voting rights in cross border situations and where necessary to simplify the depository chain. Moreover, notice periods should ensure that foreign investors in effect have the same opportunities to exercise their ownership functions as domestic investors. To further facilitate voting by foreign investors, laws, regulations and corporate practices should allow participation through electronic means in a non-discriminatory way.

D. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

It has long been recognized that in companies with dispersed ownership, individual shareholders might have too small a stake in the company to warrant the cost of taking action or for making an investment in monitoring performance. Moreover, if small shareholders did invest resources in such activities, others would also gain without having contributed (i.e. they are “free riders”). This effect, which serves to lower incentives for monitoring, is probably less of a problem for institutions, particularly financial institutions acting in a fiduciary capacity, in deciding whether to increase their ownership to a significant stake in individual companies, or to rather simply diversify. However, other costs with regard to holding a significant stake might still be high. In many instances institutional investors are prevented from doing this because it is beyond their capacity or would require investing more of their assets in one company than may be prudent. To overcome this asymmetry which favors diversification, they should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to improve its corporate governance. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation.

It must be recognized, however, that co-operation among investors could also be used to manipulate markets and to obtain control over a company without being subject to any takeover or disclosure regulations. Moreover, cooperation might also be for the purposes of circumventing competition law. However, if co-operation does not involve issues of corporate control, or conflict with concerns about market efficiency and fairness, the benefits of more effective ownership may still be obtained. To provide clarity among shareholders, regulators may issue guidance on forms of co-ordination and agreements that do or do not constitute such acting in concert in the context of takeover and other rules.

E. All shareholders of the same series of a class should be treated equally. Capital structures and arrangements that enable certain shareholders to obtain a degree of influence or control disproportionate to their equity ownership should be disclosed.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in economic or voting rights should be subject to approval by those classes of shares which are negatively affected.

   The optimal capital structure of the firm is best decided by the management and the board, subject to the approval of the shareholders. Some companies issue preferred (or preference) shares which have a preference in respect of receipt of the profits of the firm but which normally have limited or no voting rights. Companies may also issue participation certificates or shares with limited or no voting rights, which would presumably trade at different prices than shares with full voting rights. All of these structures may be effective in distributing risk and reward in ways that are thought to be in the best interests of the company and to cost-efficient financing.

   Investors can expect to be informed regarding their voting rights before they invest. Once they have invested, their rights should not be changed unless those holding voting shares have had the opportunity to participate in the decision. Proposals to change the voting rights of different series and classes of shares should be submitted for approval at general shareholders meetings by a specified (normally higher) majority of voting shares in the affected categories.

2. The disclosure of capital structures and control arrangements should be required.

   Some capital structures allow a shareholder to exercise a degree of control over the corporation disproportionate to the shareholders' equity ownership in the company. Pyramid structures, cross shareholdings and shares with limited or multiple voting rights can be used to diminish the capability of non-controlling shareholders to influence corporate policy.

   In addition to ownership relations, other devices can affect control over the corporation. Shareholder agreements are a common means for groups of shareholders, who individually may hold relatively small shares of total equity, to act in concert so as to constitute an effective majority, or at least the largest single block of shareholders. Shareholder agreements usually give those participating in the agreements preferential rights to purchase shares if other parties to the agreement wish to sell. These agreements can also contain provisions that require those accepting the agreement not to sell their shares for a specified time. Shareholder agreements can cover issues such as how the board or the Chairman will be selected. The agreements can also oblige those in the agreement to vote as a block. Some countries have found it necessary to closely monitor such agreements and to limit their duration.

   Voting caps limit the number of votes that a shareholder may cast, regardless of the number of shares the shareholder may actually possess. Voting caps therefore redistribute control and may affect the incentives for shareholder participation in shareholder meetings.

Given the capacity of these mechanisms to redistribute the influence of shareholders on company policy, the disclosure of such capital structures and arrangements should be required. Disclosure about such schemes also allows shareholders and potential investors to make better informed decisions.

F. Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders.

1. Conflicts of interest inherent in related-party transactions should be addressed.

The potential abuse of related party transactions is an important policy issue in all markets, but particularly in those where corporate ownership is concentrated and corporate groups prevail. Banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure. This is all the more important where significant portions of income and/or costs arise from transactions with related parties.

Jurisdictions should put in place an effective framework for clearly flagging these transactions. They include broad but precise definitions of what is understood to be a related party as well as rules to disregard some of these transactions when they are not material because they do not exceed ex ante thresholds, can be regarded as recurrent and taking place at verifiable market terms or taking place with subsidiaries where no specific interest of a related party is present. Once the related party transactions have been identified, jurisdictions set procedures for approving them in a manner that minimizes their negative potential. In most jurisdictions, great emphasis is placed on board approval, often with a prominent role for independent board members, or a requirement for the board to justify the interest of the transaction for the company. Shareholders may also be given a say in approving certain transactions, with interested shareholders excluded.

2. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

Members of the board, key executives and, in some jurisdictions, controlling shareholders have an obligation to inform the board where they have a business, family or other special relationship outside of the company that could affect their judgment with respect to a particular transaction or matter affecting the company. Such special relationships include situations where executives and board members have a relationship with the company via their association with a shareholder who is in a position to exercise control. Where a material interest has been declared, it is good practice for that person not to be involved in any decision involving the transaction or matter and for the decision of the board to be specifically motivated against the presence of such interests and/or to justify the interest of the transaction for the company, notably by mentioning the terms of the transaction.

G. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited.

Many publicly traded companies have a large controlling shareholder. While the presence of a controlling shareholder can reduce the agency problem by closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company. Abusive self-dealing occurs when persons having close relationships to the company, including controlling shareholders, exploit those relationships to the detriment of the company and investors.

The potential for abuse is marked where the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume as owners through exploiting legal devices to separate ownership from control, such as pyramid structures or multiple voting rights. Such abuse may be carried out in various ways, including the extraction of direct private benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic bias in business decisions and changes in the capital structure through special issuance of shares favoring the controlling shareholder.

In addition to disclosure, a key to protecting minority shareholders is a clearly articulated duty of loyalty by board members to the company and to all shareholders. Indeed, abuse of minority shareholders is most pronounced in those countries where the legal and regulatory framework is weak in this regard. A particular issue arises in some jurisdictions where groups of companies are prevalent and where the duty of loyalty of a board member might be ambiguous and even interpreted as to the group. In these cases, some countries have developed sets of rules to control negative effects, including by specifying that a transaction in favor of another group company must be offset by receiving a corresponding benefit from other companies of the group.

Other common provisions to protect minority shareholders, which have proven effective, include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board. Under certain circumstances, some jurisdictions require or permit controlling shareholders to buy-out the remaining shareholders at a share-price that is established through an independent appraisal. This is particularly important when controlling shareholders decide to de-list an enterprise. Other means of improving minority shareholder rights include derivative (including multiple) and class action law suits. Some regulators have established complaint facilities, and some have the possibility to support lawsuits through disclosure of relevant information and/or funding. With the common aim of improving market credibility, the choice and ultimate design of different provisions to protect minority shareholders necessarily depends on the overall regulatory framework and the national legal system.

H. Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of

substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

In some jurisdictions, companies employ anti-take-over devices. However, both investors and stock exchanges have expressed concern over the possibility that widespread use of anti-take-over devices may be a serious impediment to the functioning of the market for corporate control. In some instances, take-over defenses can simply be devices to shield the management or the board from shareholder monitoring. In implementing any anti-takeover devices and in dealing with take-over proposals, the fiduciary duty of the board to shareholders and the company must remain paramount. Some jurisdictions provide options for exit to dissenting shareholders in case of major corporate restructurings including mergers and amalgamations.

Principle 3:

Institutional investors, stock markets, and other intermediaries

The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.

In order to be effective, the legal and regulatory framework for corporate governance must be developed with a view to the economic reality in which it is to be implemented. In many jurisdictions, the real world of corporate governance and ownership is no longer characterized by a straight and uncompromised relationship between the performance of the company and the income of the ultimate beneficiaries of shareholdings. In reality, the investment chain is often long and complex, with numerous intermediaries that stand between the ultimate beneficiary and the company. The presence of intermediaries acting as independent decision makers influences the incentives and the ability to engage in corporate governance.

The share of equity investments held by institutional investors such as mutual funds, pension funds, insurance companies and hedge funds has increased significantly, and many of their assets are managed by specialized asset managers. The ability and interest of institutional investors and asset managers to engage in corporate governance varies widely. For some, engagement in corporate governance, including the exercise of voting rights, is a natural part of their business model. Others may offer their beneficiaries and clients a business model and investment strategy that does not include or motivate spending resources on active shareholder engagement. If shareholder engagement is not part of the institution's business model and investment strategy, mandatory requirements to engage, for example through voting, may be in effective and lead to a box-ticking approach.

The Principles recommend that institutional investors disclose their policies with respect to corporate governance. Voting at shareholder meetings is, however, only one channel for shareholder engagement. Direct contact and dialogue with the board and management, represent other forms of shareholder engagement that are frequently used. In recent years, some countries have begun to consider adoption of codes on shareholder engagement ("stewardship codes") that institutional investors are invited to sign up to on a voluntary basis.

A. Institutional investors acting in a fiduciary capacity should disclose their corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

The effectiveness and credibility of the entire corporate governance framework and company oversight depend to a large extent on institutional investors' willingness and ability to make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest. While this principle does not require institutional investors to vote their shares, it calls for disclosure of how they exercise their ownership rights with due consideration to cost effectiveness. For institutions acting in a fiduciary capacity, such as pension funds, collective investment schemes and some activities of insurance companies, and asset managers acting on their behalf, the right to vote can be considered part of the value of the investment being undertaken on behalf of their clients. Failure to exercise the ownership rights could result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investors.

In some countries, the demand for disclosure of corporate governance policies to the market is quite detailed and includes requirements for explicit strategies regarding the circumstances in which the institution will intervene in a company; the approach they will use for such intervention; and how they will assess the effectiveness of the strategy. Disclosure of actual voting records is regarded as good practice, especially where an institution has a declared policy to vote. Disclosure is either to their clients (only with respect to the securities of each client) or, in the case of investment advisors to registered investment companies, to the market. A complementary approach to participation in shareholders' meetings is to establish a continuing dialogue with portfolio companies. Such a dialogue between institutional investors and companies should be encouraged, although it is incumbent on the company to treat all investors equally and not to divulge information to the institutional investors which is not at the same time made available to the market. The additional information provided by a company would normally therefore include general background information about the markets in which the company is operating and further elaboration of information already available to the market.

When institutional investors have developed and disclosed a corporate governance policy, effective implementation requires that they also set aside the appropriate human and financial resources to pursue this policy in a way that their beneficiaries and portfolio companies can expect. The nature and practical implementation of an active corporate governance policy by such institutional investors, including staffing, should be transparent to clients who rely on institutional investors with active corporate governance policies.

B. Votes should be cast by custodians or nominees in line with the directions of the beneficial owner of the shares.

Custodian institutions holding securities as nominees for customers should not be permitted to cast the votes on those securities unless they have received specific instructions to do so. In some jurisdictions, listing requirements contain broad lists of items on which custodians may not vote without instruction, while leaving this possibility open for certain routine items. Rules should require custodian institutions to provide shareholders with timely information concerning their options in the exercise of their voting rights. Shareholders may elect to vote by themselves or to delegate all voting rights to custodians. Alternatively, shareholders may choose to be informed of all upcoming shareholder votes and may decide to cast some votes while delegating some voting rights to the custodian.

Holders of depository receipts should be provided with the same ultimate rights and practical opportunities to participate in corporate governance as are accorded to holders of the underlying shares. Where the direct holders of shares may use proxies, the depositary, trust office or equivalent body should therefore issue proxies on a timely basis to depository receipt holders. The depository receipt holders should be able to issue binding voting instructions with respect to the shares, which the depositary or trust office holds on their behalf.

It should be noted that this principle does not apply to the exercise of voting rights by trustees or other persons acting under a special legal mandate (such as, for example, bankruptcy receivers and estate executors).

C. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

The incentives for intermediary owners to vote their shares and exercise key ownership functions may, under certain circumstances, differ from those of direct owners. Such differences may sometimes be commercially sound but may also arise from conflicts of interest which are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group. When such conflicts arise from material business relationships, for example, through an agreement to manage the portfolio company's funds, such conflicts should be identified and disclosed.

At the same time, institutions should disclose what actions they are taking to minimize the potentially negative impact on their ability to exercise key ownership rights. Such actions may include the separation of bonuses for fund management from those related to the acquisition of new business elsewhere in the organization. Fee structures for asset management and other intermediary services should be transparent.

D. The corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimize conflicts of interest that might compromise the integrity of their analysis or advice.

The investment chain from ultimate owners to corporations does not only involve multiple intermediary owners. It also includes a wide variety of professions that offer advice and services to intermediary owners. Proxy advisors who offer recommendations to institutional investors on how to vote and to sell services that help in the process of voting are among the most relevant from a direct corporate governance perspective. In some cases, proxy advisors also offer corporate governance related consulting services to corporations. Other service providers rate companies according to various corporate governance criteria. Analysts, brokers and rating agencies, perform similar roles and face the same potential conflicts of interest.

Considering the importance of – and sometimes dependence on –various services in corporate governance, the corporate governance framework should promote the integrity of professions such as analysts, brokers, rating agencies, and proxy advisors. When managed appropriately, these can play an important role in shaping good corporate governance practices. At the same time, conflicts of interest may arise and affect judgment, such as when the provider of advice is also seeking to provide other services to the company in question, or where the provider has a direct material interest in the company or its competitors. Many jurisdictions have adopted regulations or encouraged the implementation of self-regulatory codes designed to mitigate such conflicts of interest or other risks related to integrity, and have provided for private and/or public monitoring arrangements.

Providers of proxy advisory services should, where appropriate in each context, disclose publicly and/or to investor clients the process and methodology that underpin their recommendations, and the criteria for their voting policies relevant for their clients.

E. Insider trading and market manipulation should be prohibited and the applicable rules enforced.

As insider trading entails manipulation of the capital markets, it is prohibited by securities regulations, company law and/or criminal law in most countries. These practices can be seen as constituting a breach of good corporate governance as they violate the principle of equitable treatment of shareholders. However, the effectiveness of such prohibition depends on vigorous enforcement action.

F. For companies who are listed in a jurisdiction other than their jurisdiction of incorporation, the applicable corporate governance laws and regulations should be clearly disclosed. In the case of cross listings, the criteria and procedure for recognizing the listing requirements of the primary listing should be transparent and documented.

It is increasingly common that companies are listed or traded at venues located in a different jurisdiction than the one where the company is incorporated. This may create uncertainty among investors about which corporate governance rules and regulations apply for that company. It may concern everything from procedures and locations for the annual shareholders meeting, to minority rights. The company should therefore clearly disclose which jurisdiction's rules are applicable. When key corporate governance provisions fall under another jurisdiction than the jurisdiction of trading, the main differences should be noted.

Another important consequence of increased internationalization and integration of stock markets is the prevalence of secondary listings of an already listed company on another stock exchange, so called cross-listings. Companies with cross-listings are often subject to the regulations and authorities of the jurisdiction where they have their primary listing. In case of a secondary listing, exceptions from local listing rules are typically granted based on the recognition of the listing requirements and corporate governance regulations of the exchange where the company has its primary listing. Stock markets should clearly disclose the rules and procedures that apply to cross-listings and related exceptions from local corporate governance rules.

G. Stock markets should provide fair and efficient price discovery as a means to help promote effective corporate governance.

Effective corporate governance means that shareholders should be able to monitor and assess their corporate investments by comparing market-related information with the company's information about its prospects and performance. When shareholders believe it is advantageous, they can either use their voice to influence corporate behavior, sell their shares (or buy additional shares), or re-evaluate a company's shares in their portfolios. The quality of and access to market information including fair and efficient price discovery regarding their investments is therefore important for shareholders to exercise their rights.

Principle 4:

The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A key aspect of corporate governance is concerned with ensuring the flow of external capital to companies both in the form of equity and credit. Corporate governance is also concerned with finding ways to encourage the various stakeholders in the firm to undertake economically optimal levels of investment in firm-specific human and physical capital. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, customers and suppliers, and other stakeholders. Corporations should recognize that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long- term interest of corporations to foster wealth-creating co-operation among stakeholders. The governance framework should recognize the interests of stakeholders and their contribution to the long-term success of the corporation.

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

The rights of stakeholders are often established by law (e.g. labor, business, commercial, environmental, and insolvency laws) or by contractual relations that companies must respect. Nevertheless, even in areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders, and concern over corporate reputation and corporate performance often requires the recognition of broader interests. For multinational enterprises, this may in some jurisdictions be achieved by companies using the OECD Guidelines for Multinational Enterprises for due diligence procedures that address the impact of such commitments.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

The legal framework and process should be transparent and not impede the ability of stakeholders to communicate and to obtain redress for the violation of rights.

C. Mechanisms for employee participation should be permitted to develop.

The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well. In the context of corporate governance, mechanisms for participation may benefit companies directly as well as indirectly through the readiness by employees to invest in firm specific skills. Examples of mechanisms for employee participation include: employee representation on boards; and governance processes such as works councils that consider employee viewpoints in certain key decisions. International conventions and national norms also recognize the rights of employees to information, consultation and negotiation. With respect to performance enhancing mechanisms, employee stock ownership plans or other profit sharing mechanisms are to be found in many countries. Pension commitments are also often an element of the relationship between the company and its past and present employees. Where such commitments involve establishing an independent fund, its trustees should be independent of the company's management and manage the fund for all beneficiaries.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

Where laws and practice of corporate governance frameworks provide for participation by stakeholders, it is important that stakeholders have access to information necessary to fulfill their responsibilities.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company and its shareholders in terms of reputation effects and an increasing risk of future financial liabilities. It is therefore to the advantage of the company and its shareholders to establish procedures and safe-harbors for complaints by employees, either personally or through their representative bodies, and others outside the company, concerning illegal and unethical behavior. The board should be encouraged by laws and or principles to protect these individuals and representative bodies and to give them confidential direct access to someone independent on the board, often a member of an audit or an ethics committee. Some companies have established an ombudsman to deal with complaints. Several regulators have also established confidential phone and e-mail facilities to receive allegations. While in certain countries representative employee bodies undertake the tasks of conveying concerns to the company, individual employees should not be precluded from, or be less protected, when acting alone. In the absence of timely remedial action or in the face of reasonable risk of negative employment action to a complaint regarding contravention of the law, employees are encouraged to report their bona fide complaint to the competent authorities. Many countries also provide for the possibility to bring cases of violations of the OECD Guidelines for Multinational Enterprises to the National Contact Point. The company should refrain from discriminatory or disciplinary actions against such employees or bodies.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

Creditors are a key stakeholder and the terms, volume and type of credit extended to firms will depend importantly on their rights and on their enforceability. Companies with a good corporate governance record are often able to borrow larger sums and on more favorable terms than those with poor records or which operate in less transparent markets. The framework for corporate insolvency varies widely across countries. In some countries, when companies are nearing insolvency, the legislative framework imposes a duty on directors to act in the interests of creditors, who might therefore play a prominent role in the governance of the company. Other countries have mechanisms which encourage the debtor to reveal timely information about the company's difficulties so that a consensual solution can be found between the debtor and its creditors.

Creditor rights also vary, ranging from secured bond holders to unsecured creditors. Insolvency procedures usually require efficient mechanisms for reconciling the interests of different classes of creditors. In many jurisdictions provision is made for special rights such as through "debtor in possession "financing which provides incentives/protection for new funds made available to the enterprise in bankruptcy.

Principle 5:

Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

In most countries a large amount of information, both mandatory and voluntary, is compiled on publicly traded and large unlisted enterprises, and subsequently disseminated to a broad range of users. Public disclosure is typically required, at a minimum, on an annual basis though some countries require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company. Companies often make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand.

The Principles support timely disclosure of all material developments that arise between regular reports. They also support simultaneous reporting of material or required information to all shareholders in order to ensure their equitable treatment. In maintaining close relations with investors and market participants, companies must be careful not to violate this fundamental principle of equitable treatment.

Disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. Nor are companies expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor. In order to determine what information should be disclosed at a minimum, many countries apply the concept of materiality. Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information. Material information can also be defined as information that a reasonable investor would consider important in making an investment or voting decision.

A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their shareholder rights on an informed basis. Experience shows that disclosure can also be a powerful tool for influencing the behavior of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in the capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behavior and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in a poor allocation of resources.

Disclosure also helps improve public understanding of the structure and activities of enterprises, corporate policies and performance with respect to environmental and ethical standards, and companies' relationships with the communities in which they operate. The OECD Guidelines for Multinational Enterprises may, in many jurisdictions be relevant for multinational enterprises.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.

   Audited financial statements showing the financial performance and the financial situation of the company (most typically including the balance sheet, the profit and loss statement, the cash flow statement and notes to the financial statements) are the most widely used source of information on companies. They enable appropriate monitoring to take place and also help to value securities. Management's discussion and analysis of operations is typically included in annual reports. This discussion is most useful when read in conjunction with the accompanying financial statements. Investors are particularly interested in information that may shed light on the future performance of the enterprise.

   Arguably, failures of governance can often be linked to the failure to disclose the "whole picture", particularly where off-balance sheet items are used to provide guarantees or similar commitments between related companies. It is therefore important that transactions relating to an entire group of companies be disclosed in line with high quality internationally recognized standards and include information about contingent liabilities and off-balance sheet transactions, as well as special purpose entities.

2. Company objectives and non-financial information.

In addition to their commercial objectives, companies are encouraged to disclose policies and performance relating to business ethics, the environment and, where material to the company, social issues, human rights and other public policy commitments. Such information may be important for certain investors and other users of information to better evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

In many countries, such disclosures are required for large companies, typically as part of their management reports, or companies disclose nonfinancial information voluntarily. This may include disclosure of donations for political purposes, particularly where such information is not easily available through other disclosure channels.

Some countries require additional disclosures for large companies, for example net turnover figures or payments made to governments broken down by categories of activity and country (country-by-country reporting).

3. Major share ownership, including beneficial owners, and voting rights.

One of the basic rights of investors is to be informed about the ownership structure of the enterprise and their rights vis-à-vis the rights of other owners. The right to such information should also extend to information about the structure of a group of companies and intra-group relations. Such disclosures should make transparent the objectives, nature and structure of the group. Disclosure of ownership data should be provided once certain thresholds of ownership are passed. Such disclosure might include data on major shareholders and others that, directly or indirectly, significantly influence or control or may significantly influence or control the company through, for example, special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, significant cross shareholding relationships and cross guarantees. It is also good practice to disclose shareholdings of directors, including non-executives.

Particularly for enforcement purposes, and to identify potential conflicts of interest, related party transactions and insider trading, information about record ownership needs to be complemented with current information about beneficial ownership. In cases where major shareholdings are held through intermediary structures or arrangements, information about the beneficial owners should therefore be obtainable at least by regulatory and enforcement agencies and/or through the judicial process. In addition, the OECD template Options for Obtaining Beneficial Ownership and Control Information and the Financial Action Task Force's Guidance on Transparency and Beneficial Ownership can be useful in this regard.

4. Remuneration of members of the board and key executives.

Information about board and executive remuneration is also of concern to shareholders. Of particular interest is the link between remuneration and long-term company performance. Companies are generally expected to disclose information on the remuneration of board members and key executives so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance. Disclosure on an individual basis (including termination and retirement provisions) is increasingly regarded as good practice and is now mandated in many countries. In these cases, some jurisdictions call for remuneration of a certain number of the highest paid executives to be disclosed, while in others it is confined to specified positions.

5. Information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

   Investors require information on individual board members and key executives in order to evaluate their experience and qualifications and assess any potential conflicts of interest that might affect their judgment. For board members, the information should include their qualifications, share ownership in the company, membership of other boards, other executive positions, and whether they are considered by the board to be an independent member. It is important to disclose membership of other boards not only because it is an indication of experience and possible time pressures facing a member of the board, but also because it may reveal potential conflicts of interest and makes transparent the degree to which there are inter-locking boards.

   National principles, and in some cases laws, lay down specific duties for board members who can be regarded as independent and recommend that a significant part, in some instances a majority, of the board should be independent. It should be incumbent on the board to set out the reasons why a member of the board can be considered independent. It is then up to the shareholders, and ultimately the market, to determine if those reasons are justified. Several countries have concluded that companies should disclose the selection process and especially whether it was open to a broad field of candidates. Such information should be provided in advance of any decision by the general shareholder's meeting or on a continuing basis if the situation has changed materially.

6. Related party transactions.

To ensure that the company is being run with due regard to the interests of all its investors, it is essential to fully disclose all material related party transactions and the terms of such transactions to the market individually. In many jurisdictions this is indeed already a legal requirement. In case the jurisdiction does not define materiality, companies should be required to also disclose the policy/criteria adopted for determining material related party transactions. Related parties should at least include entities that control or are under common control with the company, significant shareholders including members of their families and key management personnel. While the definition of related parties in internationally accepted accounting standards provides a useful reference, the corporate governance framework should ensure that all related parties are properly identified and that in cases where specific interests of related parties are present, material transactions with consolidated subsidiaries are also disclosed.

Transactions involving the major shareholders (or their close family, relations, etc.), either directly or indirectly, are potentially the most difficult type of transactions. In some jurisdictions, shareholders above a limit as low as 5 per cent shareholding are obliged to report transactions. Disclosure requirements include the nature of the relationship where control exists and the nature and amount of transactions with related parties, grouped as appropriate. Given the inherent opaqueness of many transactions, the obligation may need to be placed on the beneficiary to inform the board about the transaction, which in turn should make a disclosure to the market. This should not absolve the firm from maintaining its own monitoring, which is an important task for the board.

To make disclosure more informative, some jurisdictions distinguish related party transactions according to their materiality and conditions. Ongoing disclosure of material transactions is required, with a possible exception for recurrent transactions on “market terms”, which can be disclosed only in periodic reports. To be effective, disclosure thresholds may need to be based mainly on quantitative criteria, but avoidance of disclosure through splitting of transactions with the same related party should not be permitted.

7. Foreseeable risk factors.

Users of financial information and market participants need information on reasonably foreseeable material risks that may include: risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities; financial market risks including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; business conduct risks; and risks related to the environment.

The Principles envision the disclosure of sufficient and comprehensive information to fully inform investors of the material and foreseeable risks of the enterprise. Disclosure of risk is most effective when it is tailored to the particular company and industry in question. Disclosure about the system for monitoring and managing risk is increasingly regarded as good practice.

8. Issues regarding employees and other stakeholders.

   Companies are encouraged, and in some countries even obliged, to provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company or that may have significant impacts upon them. Disclosure may include management/employee relations, including remuneration, collective bargaining coverage, and mechanisms for employee representation, and relations with other stakeholders such as creditors, suppliers, and local communities.

   Some countries require extensive disclosure of information on human resources. Human resource policies, such as programs for human resource development and training, retention rates of employees and employee share ownership plans, can communicate important information on the competitive strengths of companies to market participants.

9. Governance structures and policies, including the content of any corporate governance code or policy and the process by which it is implemented.

Companies should report their corporate governance practices, and such disclosure should be mandated as part of the regular reporting. Companies should implement corporate governance principles set, or endorsed, by the regulatory or listing authority with mandatory reporting on a "comply or explain" or similar basis. Disclosure of the governance structures and policies of the company, including, in the case of non-operating holding companies, that of significant subsidiaries, is important for the assessment of a company's governance and should cover the division of authority between shareholders, management and board members. Companies should clearly disclose the different roles and responsibilities of the CEO and/or Chair and, where a single person combines both roles, the rationale for this arrangement. It is also good practice to disclose the articles of association, board charters and, where applicable, committee structures and charters.

As a matter of transparency, procedures for shareholders meetings should ensure that votes are properly counted and recorded, and that a timely announcement of the outcome is made.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial reporting.

The application of high quality accounting and disclosure standards is expected to significantly improve the ability of investors to monitor the company by providing increased relevance, reliability and comparability of reporting, and improved insight into company performance. Most countries mandate the use of internationally recognized standards for financial reporting, which can serve to improve transparency and the comparability of financial statements and other financial reporting between countries. Such standards should be developed through open, independent, and public processes involving the private sector and other interested parties such as professional associations and independent experts. High quality domestic standards can be achieved by making them consistent with one of the internationally recognized accounting standards. In many countries, listed companies are required to use these standards.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in accordance with high-quality auditing standards in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

In addition to certifying that the financial statements represent fairly the financial position of a company, the audit statement should also include an opinion on the way in which financial statements have been prepared and presented. This should contribute to an improved control environment in the company. In some jurisdictions, the external auditors are also required to report on the company's corporate governance.

The independence of auditors and their accountability to shareholders should be required. The designation of an audit regulator independent from the profession, consistent with the Core Principles of the International Forum of Independent Audit Regulators (IFIAR), is an important factor in improving audit quality.

It is good practice for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly. Moreover, the IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence states that, "standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation".

The audit committee or an equivalent body should provide oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor including the nature of non-audit services provided by the auditor to the company. Provision of non-audit services by the external auditor to a company can significantly impair their independence and might involve them auditing their own work. To deal with the skewed incentives which may arise, the disclosure of payments to external auditors for non-audit services should be required. Examples of other provisions designed to promote auditor independence include, a total ban or severe limitation on the nature of non-audit work which can be undertaken by an auditor for their audit client, mandatory rotation of auditors (either partners or in some cases the audit partnership), a fixed tenure for auditors, joint audits, a temporary ban on the employment of an ex-auditor by the audited company and prohibiting auditors or their dependents from having a financial stake or management role in the companies they audit. Some countries take a more direct regulatory approach and limit the percentage of non-audit income that the auditor can receive from a particular client or limit the total percentage of auditor income that can come from one client.

An issue which has arisen in some jurisdictions concerns the pressing need to ensure the competence of the audit profession. A registration process for individuals to confirm their qualifications is considered good practice. This needs, however, to be supported by ongoing training and monitoring of work experience to ensure appropriate levels of professional competence and skepticism.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

The practice that external auditors are recommended by an independent audit committee of the board or an equivalent body and that external auditors are appointed either by that committee/body or by the shareholders' meeting directly can be regarded as good practice since it clarifies that the external auditor should be accountable to the shareholders. It also underlines that the external auditor owes a duty of due professional care to the company rather than any individual or group of corporate managers that they may interact with for the purpose of their work.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

Channels for the dissemination of information can be as important as the content of the information itself. While the disclosure of information is often provided for by legislation, filing and access to information can be cumbersome and costly. Filing of statutory reports has been greatly enhanced in some countries by electronic filing and data retrieval systems. Countries should move to the next stage by integrating different sources of company information, including shareholder filings. Company websites also provide the opportunity for improving information dissemination, and some countries now require companies to have a website that provides relevant and significant information about the company itself.

Provisions for ongoing disclosure which includes periodic disclosure and continuous or current disclosure which must be provided on an ad hoc basis should be required. With respect to continuous/current disclosure, good practice is to call for “immediate” disclosure of material developments, whether this means “as soon as possible” or is defined as a prescribed maximum number of specified days. The IOSCO Principles for Periodic Disclosure by Listed Entities set guidance for the periodic reports of companies that have securities listed oradmitted to trading on a regulated market on which retail investors participate. The IOSCO Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities set forth common principles of ongoing disclosure and material development reporting for listed companies.

Principle 6:

The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.

Board structures and procedures vary both within and among countries. Some countries have two-tier boards that separate the supervisory function and the management function into different bodies. Such systems typically have a "supervisory board” composed of non-executive board members and a "management board” composed entirely of executives. Other countries have “unitary” boards, which bring together executive and non-executive board members. In some countries there is also an additional statutory body for audit purposes. The Principles are intended to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management.

Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfill their responsibilities they must be able to exercise objective and independent judgment. Another important board responsibility is to oversee the risk management system and systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labor, environmental, equal opportunity, health and safety laws. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context.

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

In some countries, the board is legally required to act in the interest of the company, taking into account the interests of shareholders, employees, and the public good. Acting in the best interest of the company should not permit management to become entrenched.

This principle states the two key elements of the fiduciary duty of board members: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions there is a standard of reference which is the behavior that a reasonably prudent person would exercise in similar circumstances. In nearly all jurisdictions, the duty of care does not extend to errors of business judgments so long as board members are not grossly negligent and a decision is made with due diligence, etc. The principle calls for board members to act on a fully informed basis. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board advocated by the Principles. In many jurisdictions this meaning is already considered an element of the duty of care, while in others it is required by securities regulation, accounting standards, etc. The duty of loyalty is of central importance, since it underpins effective implementation of other principles in this document relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

In carrying out its duties, the board should not be viewed, or act, as an assembly of individual representatives for various constituencies. While specific board members may indeed be nominated or elected by certain shareholders (and sometimes contested by others) it is an important feature of the board's work that board members when they assume their responsibilities carry out their duties in an even-handed manner with respect to all shareholders. This principle is particularly important to establish in the presence of controlling shareholders that de facto may be able to select all board members.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

The board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop company codes of conduct based on, inter alia, professional standards and sometimes broader codes of behavior, and to communicate them throughout the organization. The latter might include a voluntary commitment by the company (including its subsidiaries) to comply with the OECD Guidelines for Multinational Enterprises which reflect all four principles contained in the ILO Declaration on Fundamental Principles and Rights at Work. Similarly, jurisdictions are increasingly demanding that boards oversee the finance and tax planning strategies management is allowed to conduct, thus discouraging practices, for example the pursuit of aggressive tax avoidance, that do not contribute to the long term interests of the company and its shareholders, and can cause legal and reputational risks.

Company-wide codes serve as a standard for conduct by both the board and key executives, setting the framework for the exercise of judgment in dealing with varying and often conflicting constituencies. At a minimum, the ethical code should set clear limits on the pursuit of private interests, including dealings in the shares of the company. An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

D. The board should fulfill certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

An area of increasing importance for boards and which is closely related to corporate strategy is oversight of the company's risk management. Such risk management oversight will involve oversight of the accountabilities and responsibilities for managing risks, specifying the types and degree of risk that a company is willing to accept in pursuit of its goals, and how it will manage the risks it creates through its operations and relationships. It is thus a crucial guideline for management that must manage risks to meet the company's desired risk profile.

2. Monitoring the effectiveness of the company's governance practices and making changes as needed.

   Monitoring of governance by the board also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organization. In addition to requiring the monitoring and disclosure of corporate governance practices on a regular basis, many countries have moved to recommend, or indeed mandate, self-assessment by boards of their performance as well as performance reviews of individual board members and the Chair and the CEO.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

   In most two tier board systems the supervisory board is also responsible for appointing the management board which will normally comprise most of the key executives.

4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

   It is regarded as good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include measurable standards that emphasize the longer run interests of the company over short term considerations. Policy statements generally tend to set conditions for payments to board members for extra-board activities, such as consulting. They also often specify terms to be observed by board members and key executives about holding and trading the stock of the company, and the procedures to be followed in granting and re-pricing of options. In some countries, policy also covers the payments to be made when hiring and/or terminating the contract of an executive.

   In large companies, it is considered good practice that remuneration policy and contracts for board members and key executives be handled by a special committee of the board comprising either wholly or a majority of independent directors and excluding executives that serve on each other's remuneration committees, which could lead to conflicts of interest. The introduction of mauls and claw-back provisions is considered good practice. They grant the company the right to withhold and recover compensation from executives in cases of managerial fraud and other circumstances, for example when the company is required to restate its financial statements due to material noncompliance with financial reporting requirements.

5. Ensuring a formal and transparent board nomination and election process.

These Principles promote an active role for shareholders in the nomination and election of board members. The board has an essential role to play in ensuring that this and other aspects of the nominations and election process are respected. First, while actual procedures for nomination may differ among countries, the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. Second, the board has a key role in defining the general or individual profile of board members that the company may need at any given time, considering the appropriate knowledge, competencies and expertise to complement the existing skills of the board. Third, the board or nomination committee has the responsibility to identify potential candidates to meet desired profiles and propose them to shareholders, and/or consider those candidates advanced by shareholders with the right to make nominations. There are increasing calls for open search processes extending to a broad range of people.

6. Monitoring and managing potential conflicts of interest of management, boardmembers and shareholders, including misuse of corporate assets and abuse inrelated party transactions.

It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are often assigned to the internal auditor which should maintain direct access to the board. Where other corporate officers are responsible such as the general counsel, it is important that they maintain similar reporting responsibilities as the internal auditor.

In fulfilling its control oversight responsibilities it is important for the board to encourage the reporting of unethical/unlawful behavior without fear of retribution. The existence of a company code of ethics should aid this process which should be underpinned by legal protection for the individuals concerned. A contact point for employees who wish to report concerns about unethical or illegal behavior that might also compromise the integrity of financial statements should be offered by the audit committee or by an ethics committee or equivalent body.

7. Ensuring the integrity of the corporation’s accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

   The Board should demonstrate a leadership role to ensure that an effective means of risk oversight is in place. Ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organization. The board will also need to ensure that there is appropriate oversight by senior management. Normally, this includes the establishment of an internal audit system directly reporting to the board. It is considered good practice for the internal auditors to report to an independent audit committee of the board or an equivalent body which is also responsible for managing the relationship with the external auditor, thereby allowing a co-ordinate response by the board. It should also be regarded as good practice for this committee, or equivalent body, to review and report to the board the most critical accounting policies which are the basis for financial reports. However, the board should retain final responsibility for oversight of the company's risk management system and for ensuring the integrity of the reporting systems. Some jurisdictions have provided for the chair of the board to report on the internal control process. Companies with large or complex risks (financial and non-financial), not only in the financial sector, should consider introducing similar reporting systems, including direct reporting to the board, with regard to risk management.

Companies are also well advised to establish and ensure the effectiveness of internal controls, ethics, and compliance programs or measures to comply with applicable laws, regulations, and standards, including statutes criminalizing the bribery of foreign public officials, as required under the OECD Anti-Bribery Convention, and other forms of bribery and corruption. Moreover, compliance must also relate to other laws and regulations such as those covering securities, competition and work and safety conditions. Other laws that may be applicable include those relating to taxation, human rights, the environment, fraud, and money laundering. Such compliance programs will also underpin the company's ethical code. To be effective, the incentive structure of the business needs to be aligned with its ethical and professional standards so that adherence to these values is rewarded and breaches of law are met with dissuasive consequences or penalties. Compliance programs should also extend to subsidiaries and where possible to third parties, such as agents and other intermediaries, consultants, representatives, distributors, contractors and suppliers, consortia, and joint venture partners.

8. Overseeing the process of disclosure and communications.

   The functions and responsibilities of the board and management with respect to disclosure and communication need to be clearly established by the board. In some jurisdictions, the appointment of an investment relations officer who reports directly to the board is considered good practice for large listed companies.

E. The board should be able to exercise objective independent judgment on corporate affairs.

   In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgment. In the first instance this will mean independence and objectivity with respect to management with important implications for the composition and structure of the board. Board independence in these circumstances usually requires that a sufficient number of board members will need to be independent of management.

   In countries with single tier board systems, the objectivity of the board and its independence from management may be strengthened by the separation of the role of chief executive and Chair. Separation of the two posts is generally regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board’s capacity for decision making independent of management. The designation of a lead director is also regarded as a good practice alternative in some jurisdictions if that role is defined with sufficient authority to lead the board in cases where management has clear conflicts. Such mechanisms can also help to ensure high quality governance of the enterprise and the effective functioning of the board.

The Chairman or lead director may, in some countries, be supported by a company secretary. In the case of two tier board systems, consideration should be given to whether corporate governance concerns might arise if there is a tradition for the head of the lower board becoming the Chairman of the Supervisory Board on retirement.

The manner in which board objectivity might be underpinned also depends on the ownership structure of the company. A dominant shareholder has considerable powers to appoint the board and the management. However, in this case, the board still has a fiduciary responsibility to the company and to all shareholders including minority shareholders.

The variety of board structures, ownership patterns and practices in different countries will thus require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members. In others, independence from controlling shareholders or another controlling body will need to be emphasized, in particular if the ex-ante rights of minority shareholders are weak and opportunities to obtain redress are limited. This has led to both codes and the law in most jurisdictions to call for some board members to be independent of dominant shareholders, independence extending to not being their representative or having close business ties with them. In other cases, parties such as particular creditors can also exercise significant influence. Where there is a party in a special position to influence the company, there should be stringent tests to ensure the objective judgment of the board.

In defining independence for members of the board, some national principles of corporate governance have specified quite detailed presumptions for non-independence which are frequently reflected in listing requirements. While establishing necessary conditions, such “negative” criteria defining when an individual is not regarded as independent can usefully be complemented by “positive” examples of qualities that will increase the probability of effective independence.

Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defenses, large acquisitions and the audit function. In order for them to play this key role, it is desirable that boards declare who they consider to be independent and the criterion for this judgment. Some jurisdictions also require separate meetings of independent directors on a periodic basis.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.

   While the responsibility for financial reporting, remuneration and nomination are frequently with the board as a whole, independent non-executive board members can provide additional assurance to market participants that their interests are safeguarded. The board should consider establishing specific committees to consider questions where there is a potential for conflict of interest. These committees should require a minimum number or be composed entirely of non-executive members. In some countries, shareholders have direct responsibility for nominating and electing non-executive directors to specialized functions.

2. Boards should consider setting up specialized committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

   Where justified in terms of the size of the company and its board, the use of committees may improve the work of the board. In order to evaluate the merits of board committees it is important that the market receives a full and clear picture of their purpose, duties and composition. Such information is particularly important in the many jurisdictions where boards have established independent audit committees with powers to oversee the relationship with the external auditor and to act in many cases independently. Audit committees should also be able to oversee the effectiveness and integrity of the internal control system. Other such committees include those dealing with nomination, compensation, and risk. The establishment of additional committees can sometimes help avoid audit committee overload and to allow more board time to be dedicated to those issues. Nevertheless, the accountability of the rest of the board and the board as a whole should be clear. Disclosure need not extend to committees set up to deal with, for example, confidential commercial transactions.

3. Board members should be able to commit themselves effectively to their responsibilities.

Service on too many boards can interfere with the performance of board members. Some countries have limited the number of board positions that can be held. Specific limitations may be less important than ensuring that members of the board enjoy legitimacy and confidence in the eyes of shareholders. Disclosure about other board memberships to shareholders is therefore a key instrument to improve board nominations. Achieving legitimacy would also be facilitated by the publication of attendance records for individual board members (e.g. whether they have missed a significant number of meetings) and any other work undertaken on behalf of the board and the associated remuneration.

4. Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.

   In order to improve board practices and the performance of its members, an increasing number of jurisdictions now encourage companies to engage in board training and voluntary board evaluation that meet the needs of the individual company. Particularly in large companies, board evaluation can be supported by external facilitators to increase objectivity. Unless certain qualifications are required, such as for financial institutions, this might include that board members acquire appropriate skills upon appointment. Thereafter, board members may remain abreast of relevant new laws, regulations, and changing commercial and other risks through in-house training and external courses. In order to avoid groupthink and bring a diversity of thought to board discussion, boards should also consider if they collectively possess the right mix of background and competences. Countries may wish to consider measures such as voluntary targets, disclosure requirements, boardroom quotas, and private initiatives that enhance gender diversity on boards and in senior management.

F. In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

Board members require relevant information on a timely basis in order to support their decision-making. Non-executive board members do not typically have the same access to information as key managers within the company. The contributions of non-executive board members to the company can be enhanced by providing access to certain key managers within the company such as, for example, the company secretary, the internal auditor, and the head of risk management or chief risk officer, and recourse to independent external advice at the expense of the company. In order to fulfill their responsibilities, board members should ensure that they obtain accurate, relevant and timely information. Where companies rely on complex risk management models, board members should be made aware of the possible shortcomings of such models.

G. When employee representation on the board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of board skills, information and independence.

When employee representation on boards is mandated by the law or collective agreements, or adopted voluntarily, it should be applied in a way that maximizes its contribution to the board's independence, competence and information. Employee representatives should have the same duties and responsibilities as all other board members, and should act in the best interest of the company.

Procedures should be established to facilitate access to information, training and expertise, and the independence of employee board members from the CEO and management. These procedures should also include adequate, transparent appointment procedures, rights to report to employees on a regular basis –provided that board confidentiality requirements are duly respected – training, and clear procedures for managing conflicts of interest. A positive contribution to the board's work will also require acceptance and constructive collaboration by other members of the board as well as by management.

APPENDIX C

BASEL CORPORATE GOVERNANCE PRINCIPLES FOR BANKS

Principle 1:

Board's Overall Responsibilities

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, governance framework and corporate culture. The board is also responsible for providing oversight of senior management.

Responsibilities of the Board

A. The board has ultimate responsibility for the bank's business strategy and financial soundness, key personnel decisions, internal organization and governance structure and practices, and risk management and compliance obligations.

B. The board should ensure that the bank's organizational structure enables the board and senior management to carry out their responsibilities and facilitates effective decision making and good governance. This includes clearly laying out the key responsibilities and authorities of the board itself, of senior management and of those responsible for the control functions.

C. The members of the board should exercise their "duty of care" and "duty of loyalty" to the bank under applicable national laws and supervisory standards. This includes actively engaging in the major matters of the bank and keeping up with material changes in the bank's business and the external environment as well as acting in a timely manner to protect the long-term interests of the bank.

D. Accordingly, the board should:

1. establish and monitor the bank's business objectives and strategy.
2. establish the bank's corporate culture and values.
3. oversee implementation of the appropriate governance framework.
4. develop, along with senior management, the bank's risk appetite, taking into account the competitive and regulatory landscape, long-term interests, exposure to risk and the ability to manage risk effectively.
5. monitor the bank's adherence to the risk appetite statement (RAS), risk policy and risk limits.
6. approve and oversee the implementation of the bank's capital adequacy assessment process, capital and liquidity plans, compliance policies and obligations, and the internal control system.
7. approve the selection and oversee the performance of senior management.
8. oversee the design and operation of the bank's compensation system, and monitor and review the system to ensure that it is aligned with the bank's desired risk culture and risk appetite.

E. The board should ensure that transactions with related parties (including internal group transactions) are reviewed to assess risk and are subject to appropriate restrictions (e.g. by requiring that such transactions be conducted on arm's length terms) and that corporate or business resources of the bank are not misappropriated or misapplied.

F. The board should review the governance framework periodically so that it remains appropriate in the light of material changes in the bank's size, complexity, geographic reach, business strategy, market and governance best practices, and regulatory requirements.

G. In discharging these responsibilities, the board should take into account the legitimate interests of depositors, shareholders and other relevant stakeholders. It should also ensure that the bank maintains an effective relationship with its supervisors.

Corporate Culture and Values

A. A fundamental component of good governance is a demonstrated corporate culture of reinforcing appropriate norms for responsible and ethical behavior. These norms are especially critical in terms of a bank's risk awareness, risk-taking and risk management.

B. In order to promote a sound corporate culture, the board should take the lead in establishing the "tone at the top" by:

   1. setting and adhering to corporate values for itself, senior management and other employees that create expectations that all business should be conducted in a legal and ethical manner.
   2. promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that all employees are responsible for helping ensure that the bank operates within the agreed risk appetite and risk limits.
   3. ensuring that appropriate steps are taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies.
   4. ensuring that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviors and transgressions.

C. A bank's code of conduct or code of ethics, or comparable policy, should define acceptable and unacceptable behaviors.

1. It should explicitly disallow behavior that could lead to any reputation risks or improper or illegal activity, such as financial misreporting, money laundering, fraud, anti-competitive practices, bribery and corruption, or the violation of consumer rights.
2. It should make clear that employees are expected to conduct themselves ethically in addition to complying with laws, regulations and company policies.

D. The bank's corporate values should recognize the critical importance of timely and frank discussion and escalation of problems to higher levels within the organization.

1. Employees should be encouraged and able to communicate, confidentially and without the risk of reprisal, legitimate concerns about illegal, unethical or questionable practices. This can be facilitated through a well communicated policy and adequate procedures and processes, consistent with national law, which allow employees to communicate material and bona fide concerns and observations of any violations in a confidential way. This includes communicating material concerns to the bank's supervisor.
2. There should be direct or indirect communications to the board (e.g. through an independent audit or compliance process).
3. The board should determine how and by whom legitimate concerns shall be investigated and addressed by an objective independent internal or external body, senior management and/or the board itself.

Risk Appetite, Management and Control

A. As part of the overall corporate governance framework, the board is responsible for overseeing a strong risk governance framework. An effective risk governance framework includes a strong risk culture, a well-developed risk appetite framework, and well-defined responsibilities for risk management in particular and control functions in general.

B. Developing and conveying the bank's risk appetite statement (RAS) is essential to reinforcing a strong risk culture. The board should clearly outline actions to be taken when stated risk limits are breached, including disciplinary actions for excessive risk-taking, escalation procedures and board of director notification.

C. The board should take an active role in developing the risk appetite and ensuring its alignment with the bank's strategic, capital and financial plans and compensation practices. The bank's risk appetite should be clearly conveyed through risk appetite statement (RAS) that is easily understood by all relevant parties: the board itself, senior management, bank employees and the supervisor.

D. The bank's risk appetite statement (RAS) should:

    1. include both quantitative and qualitative considerations.
    2. establish the individual and aggregate level and types of risk that the bank is willing to assume in advance of and in order to achieve its business activities within its risk capacity.
    3. define the boundaries and business considerations in accordance with which the bank is expected to operate when pursuing the business strategy.
    4. communicate the board's risk appetite effectively throughout the bank, linking it to daily operational decision-making and establishing the means to raise risk issues and strategic concerns across the bank.

E. The development of an effective risk appetite statement (RAS) should be driven by both top-down board leadership and bottom-up management involvement. While risk appetite development may be initiated by senior management, successful implementation depends upon effective interactions between the board, senior management, risk management and operating businesses including the chief financial officer.

F. A risk governance framework should include well defined organizational responsibilities for risk management, typically referred to as the three lines of defense:
   1. the business line.
   2. a risk management function and a compliance function independent from the first line of defense.
   3. an internal audit function independent from the first and second lines of defense.

G. Depending on the bank's nature, size and complexity, and the risk profile of its activities, the specifics of how these three lines of defense are structured can vary. Regardless of the structure, responsibilities for each line of defense should be well defined and communicated.

H. Business units are the first line of defense. They take risks and are responsible and accountable for the ongoing management of such risks. This includes identifying, assessing and reporting such exposures, taking into account the bank's risk appetite and its policies, procedures and controls. The manner in which the business line executes its responsibilities should reflect the bank's existing risk culture.

I. The second line of defense includes an independent and effective risk management function. The risk management function complements the business line's risk activities through its monitoring and reporting responsibilities. Among other things, it is responsible for overseeing the bank's risk-taking activities and assessing risks and issues independently from the business line. The function should promote the importance of senior management and business line managers in identifying and assessing risks critically rather than relying only on surveillance conducted by the risk management function.

J. The second line of defense also includes an independent and effective compliance function. The compliance function should, among other things, routinely monitor compliance with laws, corporate governance rules, regulations, codes and policies to which the bank is subject. The board should approve compliance policies that are communicated to all staff. The compliance function should ensure that the compliance policies are observed and report to senior management and, as appropriate, to the board on how the bank is managing its compliance risk. The function should also have sufficient authority, stature, independence, resources and access to the board.

K. The third line of defense consists of an independent and effective internal audit function. Among other things, it provides independent review and assurance on the quality and effectiveness of the bank's risk governance framework including links to organizational culture, as well as strategic and business planning, compensation and decision-making processes. Internal auditors must be competent and appropriately trained and not involved in developing, implementing or operating the risk management function.

L. The board should ensure that the risk management, compliance and audit functions are properly positioned, staffed and resourced and carry out their responsibilities independently and effectively. In the board's oversight of the risk governance framework, the board should regularly review policies and controls with senior management and with the heads of the risk management, compliance and audit functions to identify and address significant risks and issues, as well as determine areas that need improvement.

Oversight of Senior Management

A. The board should select the CEO and may select other key members of senior management, as well as the heads of the control functions.
B. The board should provide oversight of senior management. It should hold members of senior management accountable for their actions and enumerate the consequences if those actions are not aligned with the board's performance expectations. This includes adhering to the bank's values, risk appetite and risk culture, regardless of financial gain or loss to the bank.

Principle 2:

Board Qualifications and Composition

Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.

Board Composition

A. The board must be suitable to carry out its responsibilities and have a composition that facilitates effective oversight. For that purpose, the board should be comprised of a sufficient number of independent directors.
B. The board should be comprised of individuals with a balance of skills, diversity and expertise, who collectively possess the necessary qualifications commensurate with the size, complexity and risk profile of the bank.
C. In assessing the collective suitability of the board, the following should be taken into account:

1. Board members should have a range of knowledge and experience in relevant areas and have varied backgrounds to promote diversity of views. Relevant areas of competence include financial and capital markets, financial analysis, financial stability, strategic planning, risk management, compensation, regulation, corporate governance and management skills.
2. The board collectively should have a reasonable understanding of local, regional and, if appropriate, global economic and market forces and of the legal and regulatory environment. International experience, where relevant, should also be considered.
3. Where board expertise is insufficient in any of the above areas, the board should be able to employ independent experts as needed.

<u>Board Member Selection and Qualifications</u>

A. Boards should have a clear and rigorous process for identifying, assessing and selecting board candidates. Unless required otherwise by law, the board (not management) identifies and nominates candidates and ensures appropriate succession planning of board members and senior management.
B. The selection process should include reviewing whether board candidates: (1) possess the knowledge, skills, experience and independence of mind given their responsibilities on the board and in the light of the bank's business and risk profile, (2) have a record of integrity and good repute, and (3) have sufficient time to fully carry out their responsibilities.
C. Board candidates should not have any conflicts of interest that may impede their ability to perform their duties objectively and subject them to undue influence from:
   1. other persons (such as management or other shareholders).

2. past or present positions held.
3. personal, professional or other economic relationships with other members of the board or management (or with other entities within the group).

D. If a board member ceases to be qualified or is failing to fulfill his or her responsibilities, the board should take appropriate actions as permitted by law, which may include notifying their banking supervisor.

E. The bank should have in place a nomination committee or similar body, composed of a sufficient number of independent board members, which identifies and nominates candidates after having taken into account the criteria described above.
    1. The nomination committee should analyze the responsibilities relating to the role the board member will play and the knowledge, experience and competence which the role requires.
    2. Where a supervisory board or board of auditors is formally separate from a management board, objectivity and independence still need to be assured by appropriate selection of board members.
    3. The nomination committee should strive to ensure that the board is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the bank as a whole.

F. In order to help board members acquire, maintain and enhance their knowledge and skills, and fulfill their responsibilities, the board should ensure that members participate in induction programs and have access to ongoing training on relevant issues. The board should dedicate sufficient time, budget and other resources for this purpose, and draw on external expertise as needed. More extensive efforts should be made to train and keep updated those members with more limited financial, regulatory or risk-related experience.

G. Where there are shareholders with power to appoint board members, the board should ensure such board members understand their duties. Board members have responsibilities to the bank's overall interests, regardless of who appoints them. In cases where board members are selected by a controlling shareholder, the board may wish to set out specific procedures or conduct periodic reviews to ensure the appropriate discharge of responsibility by all board members.

Principle 3:

Board's Own Structure and Practices

The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

Organization and Assessment of the Board

A. The board should structure itself in terms of leadership, size and the use of committees so as to effectively carry out its oversight role and other responsibilities. This includes ensuring that the board has the time and means to cover all necessary subjects in sufficient depth and have a robust discussion of issues.

B. The board should maintain and periodically update organizational rules, by-laws, or other similar documents setting out its organization, rights, responsibilities and key activities.

C. To support its own performance, the board should carry out regular assessments – alone or with the assistance of external experts – of the board as a whole, its committees and individual board members.

D. The board should maintain appropriate records (e.g. meeting minutes or summaries of matters reviewed, recommendations made and decisions taken) of its deliberations and decisions. These should be made available to the supervisor when required.

Role of the Chair

A. The chair of the board plays a crucial role in the proper functioning of the board. The chair provides leadership to the board and is responsible for its effective overall functioning, including maintaining a relationship of trust with board members. The chair should possess the requisite experience, competencies and personal qualities in order to fulfill these responsibilities. The chair should ensure that board decisions are taken on a sound and well informed basis. The chair should encourage and promote critical discussion and ensure that dissenting views can be freely expressed and discussed within the decision-making process.

B. To promote checks and balances, the chair of the board should be a non-executive board member and not serve as chair of any board committee.

C. In jurisdictions where the chair is permitted to assume executive duties, the bank should have measures in place to mitigate the adverse impact on the bank's checks and balances of such a situation. These could include having a lead board member, senior independent board member or a similar position or having a larger number of non-executives on the board so as to provide effective challenge to executive board members.

Board Committees

A. To increase efficiency and allow deeper focus in specific areas, a board may establish certain specialized board committees, unless it can demonstrate to the supervisor that it can still effectively accomplish the goals without such committees. The committees should be created and mandated by the full board. The number and nature of committees depends on many factors, including the size of the bank and its board, the nature of the business areas of the bank, and its risk profile.

B. Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures. This includes how the committee will report to the full board, what is expected of committee members and any tenure limits for serving on the committee. The board should consider the occasional rotation of members and of the chair of such committees as this can help avoid undue concentration of power and promote fresh perspectives.

C. In the interest of greater transparency and accountability, a board should disclose the committees it has established, their mandates and their composition (including members who are considered to be independent).

D. Committees should maintain appropriate records of their deliberations and decisions (e.g. meeting minutes or summaries of matters reviewed, recommendations made and decisions taken). Such records should document the committees' fulfillment of their responsibilities and help the supervisor or those responsible to assess the effectiveness of these committees.

E. A committee chair should be an independent, non-executive board member.

F. Board committees may include:

   1. Audit committee.

   2. Risk committee.

3. Compensation committee.
4. Nominations/human resources/governance committee.
5. Ethics/compliance committee.

<u>Conflicts of Interest</u>

A. Conflicts of interest may arise as a result of the various activities and roles of the bank (e.g. where the bank extends loans to a firm while its proprietary trading function buys and sells securities issued by that firm), or between the interests of the bank or its customers and those of the bank's board members or senior managers (e.g. where the bank enters into a business relationship with an entity in which one of the bank's board members has a financial interest).
B. Conflicts of interest may also arise when a bank is part of a broader group. For example, where the bank is part of a group, reporting lines and information flows between the bank, its parent company and/or other subsidiaries can lead to the emergence of conflicts of interest (e.g. sharing of potential proprietary, confidential or otherwise sensitive information from different entities or pressure to conduct business on a non-arm's length basis).
C. The board should ensure that policies to identify potential conflicts of interest are developed, implemented and monitored. Where these conflicts cannot be prevented, theyshould be properly managed (based on the permissibility of relationships or transactions under sound corporate policies consistent with national law and supervisory standards).
D. The board should have a formal written conflicts of interest policy and an objective compliance process for implementing the policy.

E. The board should ensure that appropriate public disclosure is made, and/or information is provided to supervisors, relating to the bank's policies on conflicts of interest and potential material conflicts of interest.

F. This should include information on the bank's approach to disclosing and managing material conflicts of interest that are not consistent with such policies, and conflicts that could arise because of the bank's affiliation or transactions with other entities within the group.

G. There is a potential conflict of interest where a bank is both owned by the state and subject to banking supervision by the state. If such conflicts of interest do exist, there should be full administrative separation of the ownership and banking supervision functions in order to minimize political interference in the supervision of the bank.

Principle 4:

Senior Management

Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, incentive compensation and other policies approved by the board.

A. Senior management consists of a core group of individuals who are responsible and accountable to the board for effectively overseeing the day-to-day management of the bank.

B. The organization and procedures and decision-making of senior management should be clear and transparent and designed to promote effective management of the bank. This includes clarity on the role and authority of the various positions within senior management, including the CEO.

C. Members of senior management should have the necessary experience, competencies and integrity to manage the businesses and people under their supervision. They should receive access to regular training to maintain and enhance their competencies and stay up to date on developments relevant to their areas of responsibility.

D. Members of senior management should be selected through an appropriate promotion or recruitment process which takes into account the qualifications required for the position in question. For those senior management positions for which the board of directors is required to review or select candidates through an interview process, senior management should provide sufficient information to the board.

E. Senior management contributes substantially to a bank's sound corporate governance through personal conduct (e.g. by helping to set the "tone at the top" along with the board). Members of senior management should provide adequate oversight of those they manage, and ensure that the bank's activities are consistent with the business strategy, risk appetite and the policies approved by the board.

F. Senior management is responsible for delegating duties to staff and should establish a management structure that promotes accountability and transparency throughout the bank.

G. Senior management should implement, consistent with the direction given by the board, risk management systems, processes and controls for managing the risks – both financial and non-financial – to which the bank is exposed and for complying with laws, regulations and internal policies.

H. Senior management should provide the board with the information it needs to carry out its responsibilities, supervise senior management and assess the quality of senior management's performance. In this regard, senior management should keep the board regularly and adequately informed of material matters.

Principle 5:

Governance of Group Structures

In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring that there is a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank's operational structure and the risks that it poses.

A. In operating within a group structure, 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 exercise adequate oversight over subsidiaries while respecting the independent legal and governance responsibilities that might apply to subsidiary boards.

B. In order to fulfill its responsibilities, the board of the parent company should:

   1. establish a group structure (including the legal entity and business structure) and a governance framework with clearly defined roles and responsibilities, including those at the parent company level and those at the subsidiary level.
   2. define an appropriate subsidiary board and management structure to contribute to the effective oversight of businesses and subsidiaries, which takes into account the different risks to which the group, its businesses and its subsidiaries are exposed.

3. assess whether the group's corporate governance framework includes adequate policies, processes and controls and addresses risks across the business and legal entity structures.
4. ensure the group's corporate governance framework includes appropriate processes and controls to identify and address potential intra group conflicts of interest, such as those arising from intra group transactions.
5. approve policies and clear strategies for establishing new structures and legal entities, and ensure that they are consistent with the policies and interests of the group.
6. assess whether there are effective systems in place to facilitate the exchange of information among the various entities, to manage the risks of the separate entities as well as of the group as a whole, and to ensure effective supervision of the group.
7. have sufficient resources to monitor compliance of subsidiaries with all applicable legal, regulatory and governance requirements.
8. maintain an effective relationship with both the home regulator and, through the subsidiary board or direct contact, with the regulators of all subsidiaries.

<u>Subsidiary Boards</u>

A. While the strategic objectives, risk governance framework, corporate values and corporate governance principles of the subsidiary bank should align with that of the parent company (referred to here as "group policies"), the subsidiary board should make necessary adjustments where a group policy conflicts with an applicable legal or regulatory provision or prudential rule, or would be detrimental to the sound and prudent management of the subsidiary.

B. In the case of a significant regulated subsidiary (due to its risk profile or systemic importance or due to its size relative to the parent company), the board of the significant subsidiary should take such further steps as are necessary to help the subsidiary meet its independent corporate governance responsibilities and the legal and regulatory requirements that apply to it.

<u>Complex Structures</u>

A. Banks create structures for legal, regulatory and tax purposes. Structures can take the form of units, branches, subsidiaries or other legal entities that can considerably increase the complexity of the organization. The number of legal entities, and in particular the interconnections and intra group transactions among such entities, can lead to challenges in identifying and managing the risks of the organization as a whole.

B. Operating through complex or non-transparent structures may pose financial, legal, reputational and other risks to the bank. It may impede the ability of the board and senior management to conduct appropriate business oversight and could hinder effective banking supervision. In addition, the bank may also be indirectly exposed to risk when it performs certain services or establishes structures on behalf of customers. Examples include acting as a company or partnership formation agent, providing a range of trustee services and developing complex structured finance transactions for customers. While these activities are often profitable and can serve the legitimate business purposes of customers, customers may in some cases use products and activities provided by banks to engage in illegal or inappropriate activities.

C. Senior management, and the board as appropriate, should be cognizant of these challenges and take appropriate action to avoid or mitigate them.

D. The board of the parent company can enhance the effectiveness of the above efforts by requiring a periodic independent formal review of the structures, their controls and activities, as well as their consistency with board-approved strategy.
E. The board should be prepared to discuss with, and as necessary report to, the bank's supervisor and the host country supervisors the policies and strategies adopted regarding the establishment and maintenance of these structures and activities.

Principle 6:

Risk Management

Banks should have an effective independent risk management function, under the direction of a Chief Risk Officer (CRO), with sufficient stature, independence, resources and access to the board.

A. The independent risk management function is a key component of the bank's second line of defense. This function is responsible for overseeing risk-taking activities across the enterprise. The independent risk management function (bank-wide and within subsidiaries) should have authority within the organization to oversee the bank's risk management activities.
B. While it is common for risk managers to work closely with individual business units, the risk management function should be sufficiently independent of the business units and should not be involved in revenue generation. Such independence is an essential component of an effective risk management function, as is having access to all business lines that have the potential to generate material risk to the bank as well as to relevant risk-bearing subsidiaries and affiliates.

C. The risk management function should have a sufficient number of personnel who possess the requisite experience and qualifications, including market and product knowledge as well as command of risk disciplines. Staff should have the ability and willingness to effectively challenge business lines regarding all aspects of risk arising from the bank's activities.

Role of the Chief Risk Officer (CRO)

A. Large, complex and internationally active banks, and other banks, based on their risk profile and local governance requirements, should have a senior manager (Chief Risk Officer "CRO" or equivalent) with overall responsibility for the bank's risk management function. In banking groups, there should be a group CRO in addition to subsidiary-level risk officers.

B. The CRO has primary responsibility for overseeing the development and implementation of the bank's risk management function. The CRO is responsible for supporting the board in its development of the bank's risk appetite and for translating the risk appetite into a risk limits structure. The CRO, together with management, should be actively engaged in the process of setting risk measures and limits for the various business lines and monitoring their performance relative to risk-taking and limit adherence. The CRO's responsibilities also include managing and participating in key decision-making processes (e.g. strategic planning, capital and liquidity planning, new products and services, compensation design and operation).

C. The CRO should have the organizational stature, authority and the necessary skills to oversee the bank's risk management activities. The CRO should be independent and have duties distinct from other executive functions. This requires the CRO to have access to any information necessary to perform his or her duties. The CRO, however, should not have management or financial responsibility related to any operational business lines or revenue-generating functions. While formal reporting lines may vary across banks, the CRO should report and have direct access to the board or its risk committee without impediment. The CRO should have the ability to engage with the board and with senior management on key risk issues. Interaction between the CRO and the board and/or risk committee should occur regularly, and the CRO should have the ability to meet with the board or risk committee without executive directors being present.

D. Appointment, dismissal and other changes to the CRO position should be approved by the board or its risk committee. If the CRO is removed from his or her position, this should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor. The CRO's performance, compensation and budget should be reviewed and approved by the risk committee or the board.

Principle 7:

Risk Identification, Monitoring and Controlling

Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.

A. The bank's risk governance framework should include policies, supported by appropriate control procedures and processes, designed to ensure that the bank's risk identification, aggregation, mitigation and monitoring capabilities are commensurate with the bank's size, complexity and risk profile.

B. Risk identification should encompass all material risks to the bank, on- and off-balance sheet and on a group-wide, portfolio-wise and business-line level. In order to perform effective risk assessments, the board and senior management, including the CRO, should,regularly and on an ad hoc basis, evaluate the risks faced by the bank and its overall risk profile. The risk assessment process should include ongoing analysis of existing risks as well as the identification of new or emerging risks. Risks should be captured from all organizational units that originate risk. Concentrations associated with material risks shall likewise be factored into the risk assessment.

C. Risk identification and measurement should include both quantitative and qualitative elements. Risk measurements should also include qualitative, bank-wide views of risk relative to the bank’s external operating environment. Banks should also have a method to identify and measure hard-to-quantify risks, such as reputation risk.

D. Internal controls are designed, among other things, to ensure that each key risk has a policy, process or other measure, as well as a control to ensure that such policy, process or other measure is being applied and works as intended. As such, internal controls help ensure process integrity, compliance and effectiveness. Internal controls provide reasonable assurance that financial and management information is reliable, timely and complete and that the bank is in compliance with its various policies and applicable laws and regulations.

E. In order to avoid actions beyond the authority of the individual or even fraud, internal controls also place reasonable checks on managerial and employee discretion. Even in smaller banks, for example, key management decisions should be taken by more than one person. Internal reviews should also determine the extent of a bank’s compliance with company policies and procedures, as well as with legal and regulatory policies. Adequate escalation procedures are a key element of the internal control system.

F. The sophistication of the bank's risk management infrastructure including, in particular, a sufficiently robust data, data architecture and information technology infrastructure should keep pace with developments such as balance sheet and revenue growth; increasing complexity of the bank's business, risk configuration or operating structure; geographic expansion; mergers and acquisitions; or the introduction of new products or business lines.

G. Banks must have accurate internal and external data to identify and assess risk, make strategic business decisions and determine capital and liquidity adequacy. The board and senior management should give special attention to the quality, completeness and accuracy of the data used to make risk decisions. While tools such as external credit ratings or externally purchased risk models and data can be useful as inputs into a more comprehensive assessment, banks ultimately are responsible for the assessment of their risks.

H. Risk measurement and modeling techniques should be used in addition to, but should not replace, qualitative risk analysis and monitoring. The risk management function should keep the board and senior management apprised of the assumptions used in and potential shortcomings of the bank's risk models and analyses. This helps ensure more complete and accurate reflection of exposures and may allow quicker action to address and mitigate risks.

I. As part of its quantitative and qualitative analysis, the bank should utilize stress tests and scenario analyses to better understand potential risk exposures under a variety of adverse circumstances.

J. Banks should regularly compare actual performance against risk estimates to assist in judging the accuracy and effectiveness of the risk management process and making necessary adjustments.

K. In addition to identifying and measuring risk exposures, the risk management function should evaluate possible ways to mitigate these exposures. In some cases, the risk management function may direct that risk be reduced or hedged to limit exposure. In other cases, such as when there is a decision to accept or take risk that is beyond risk limits (i.e. on a temporary basis) or take risk that cannot be hedged or mitigated, the risk management function should report and monitor the positions to ensure that they remain within the bank's framework of limits and controls or within exception approval. Either approach may be appropriate depending on the issue at hand, provided that the independence of the risk management function is not compromised.

L. Banks should have risk management and approval processes for new or expanded products or services, lines of business and markets, as well as for large and complex transactions that require significant use of resources or have hard-to-quantify risks. Banks should also have review and approval processes for outsourcing bank functions to third parties. The risk management function should provide input on risks as part of such processes and on the outsourcer's ability to manage risks and comply with legal and regulatory obligations.

M. Effective risk identification and measurement approaches are likewise necessary in subsidiary banks and affiliates. Material risk-bearing affiliates and subsidiaries should be captured by the bank-wide risk management system and should be a part of the overall risk governance framework.

N. Subsidiary boards and senior management remain responsible for developing effective risk management processes for their entities. The methods and procedures applied by subsidiaries should support the effectiveness of risk management at a group level. While parent companies should conduct strategic, group-wide risk management and prescribe corporate risk policies, subsidiary management and boards should have appropriate inputto their local or regional application and to the assessment of local risks. Parent companies should ensure that adequate tools and authorities are available to the subsidiary and that the subsidiary understands what reporting obligations it has to the head office.

O. Mergers and acquisitions, divestitures and other changes to a bank's organizational structure can pose special risk management challenges to the bank. In particular, risks can arise from conducting insufficient due diligence that fails to identify post-merger risks or activities conflicting with the bank's strategic objectives or risk appetite. The risk management function should be actively involved in assessing risks that could arise from mergers and acquisitions and report its findings directly to the board or its risk committee.

Principle 8:

Risk Communication

An effective risk governance framework requires robust communication within the bank about risk, both across the organization and through reporting to the board and senior management.

A. Ongoing communication about risk issues, including the bank's risk strategy, throughout the bank is a key tenet of a strong risk culture. A strong risk culture should promote risk awareness and encourage open communication and challenge about risk-taking across the organization as well as vertically to and from the board and senior management. Senior management should keep control functions informed of management's major plans and activities so that the control functions can properly assess the risks.

B. Information should be communicated to the board and senior management in a timely, accurate and understandable manner so that they are equipped to take informed decisions. While ensuring that the board and senior management are sufficiently informed, management and those responsible for the risk management function should avoidvoluminous information that can make it difficult to identify key issues. Rather, information should be prioritized and presented in a concise, fully contextualized manner. The board should institute periodic reviews of the relevance and accuracy of information it receives and determine if additional information is needed.

C. Material risk-related ad hoc information that requires immediate decisions or reactions should be promptly presented to senior management and the board, the responsible officers and, where applicable, the heads of control functions, so that suitable measures and activities can be initiated at an early stage. Suitable policies and procedures should be established for this purpose.

D. Risk reporting to the board requires careful design in order to ensure that bank-wide, individual portfolio and other risks are conveyed in a concise and meaningful manner. Reporting should accurately communicate risk exposures and results of stress tests or scenario analyses and should provoke a robust discussion of, for example, the bank's current and prospective exposures (particularly under stressed scenarios), risk/return relationships and risk appetite and limits. Reporting should also include information about the external environment to identify market conditions and trends that may have an impact on the bank's current or future risk profile.

E. Risk reporting systems should be dynamic, comprehensive and accurate, and should draw on a range of underlying assumptions. Risk monitoring and reporting should not only occur at the disaggregated level (including risk residing in subsidiaries that could be considered significant), but should also be aggregated to allow for a bank-wide or integrated perspective of risk exposures. Risk reporting systems should be clear about any deficiencies or limitations in risk estimates, as well as any significant embedded assumptions (e.g. regarding risk dependencies or correlations).

F. Banks should avoid organizational "silos" that can impede effective sharing of information across an organization and can result in decisions being taken in isolation from the rest of the bank. Overcoming these information-sharing obstacles may require the board, senior management and control functions to re-evaluate established practices in order to encourage greater communication.

Principle 9:

Compliance

The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should approve the bank's compliance approach and policies, including the establishment of a permanent compliance function.

A. An independent compliance function is a key component of the bank's second line of defense. This function is responsible, among other things, for promoting and monitoring that the bank operates with integrity and in compliance with applicable, laws, regulations and internal policies.

B. Compliance starts at the top. It will be most effective in a corporate culture that emphasizes standards of honesty and integrity and in which the board of directors and senior management lead by example. It concerns everyone within the bank and should be viewed as an integral part of the bank's business activities. A bank should hold itself to high standards when carrying out its business and should at all times strive to observe the spirit as well as the letter of the law. Failure to consider the impact of its actions on its shareholders, customers, employees and the markets may result in significant adverse publicity and reputational damage, even if no law has been broken.

C. The bank's senior management is responsible for establishing a written compliance approach and policies that contain the basic principles to be followed by the board, management and staff, and explains the main processes by which compliance risks are to be identified and managed through all levels of the organization. Clarity and transparency may be promoted by making a distinction between general standards for all staff members and rules that only apply to specific groups of staff.

D. While the board and management are accountable for the bank's compliance, the compliance function has an important role in supporting corporate values, policies and processes that help ensure that the bank acts responsibly and observes all obligations applicable to it.

E. The compliance function should advise the board and senior management on compliance laws, rules and standards, including keeping them informed of developments in the area. It should also help educate staff about compliance issues, act as a contact point within the bank for compliance queries from staff members, and provide guidance to staff on the appropriate implementation of compliance laws, rules and standards in the form of policies and procedures and other documents such as compliance manuals, internal codes of conduct and practice guidelines.

F. The compliance function is independent from management and provides separate reporting to the board on the bank's efforts in the above areas and on how the bank is managing its compliance risk.

G. To be effective, the compliance function must have sufficient authority, stature, independence, resources and access to the board. Management should respect the independent duties of the compliance function and not interfere with them.

H. The areas of special focus by the compliance function include those that could create reputational risk for the bank, including bribery, money laundering, country sanctions, fair treatment of the consumer and practices raising ethical issues.

Principle 10:

Internal Audit

The internal audit function provides independent assurance to the board and supports board and senior management in promoting an effective governance process and the long-term soundness of the bank. The internal audit function should have a clear mandate, be accountable to the board, be independent of the audited activities and have sufficient standing, skills, resources and authority within the bank.

A. The board and senior management should recognize and acknowledge that an independent and qualified internal audit function is vital to an effective governance process.

B. An effective internal audit function provides an independent assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organization and its reputation.

C. The internal audit function should be accountable to the board on all matters related to the performance of its mandate as described in the internal audit charter. It must be independent of the audited activities and have sufficient standing, authority and resources within the bank to enable the auditors to carry out their assignments effectively and objectively.

D. The board and senior management can enhance the effectiveness of the internal audit function by:

    1. requiring the function to independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes.
    2. requiring internal auditors to adhere to national and international professional standards, such as those established by the Institute of Internal Auditors.
    3. ensuring that audit staff have skills and resources commensurate with the business activities and risks of the bank.

E. The board and senior management should respect and promote the independence of the internal audit function.

Principle 11:

Compensation

The bank's compensation structure should be effectively aligned with sound risk management and should promote long term health of the organization and appropriate risk-taking behavior.

A. Compensation systems form a key component of the governance and incentive structure through which the board and senior management promote good performance, convey acceptable risk-taking behavior and reinforce the bank's operating and risk culture. The board is responsible for the overall oversight of the compensation system for the entire bank. In addition, the board should regularly monitor and review outcomes to ensure that the bank-wide compensation system is operating as intended. The board should review the compensation policy at least annually.

B. The Financial Stability Board (FSB) principles on compensation are intended to apply to significant financial institutions but they are especially critical for large, systemically important firms. National jurisdictions may also apply the principles in a proportionate manner to smaller, less complex institutions. Banks are encouraged to implement the FSB principles, or consistent national provisions based on them.

C. The board should approve the compensation of senior executives, including the CEO, CRO and the head of internal audit, and should oversee management's development and operation of compensation policies, systems and related control processes.

D. Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organization to oversee the compensation system's design and operation on behalf of the board of directors. The remuneration committee should be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity.

E. For employees in risk, compliance and other control functions, compensation should be determined independently of any business line overseen, and performance measures should be based principally on the achievement of their own objectives so as not to compromise their independence.

F. The compensation structure should promote long term performance and be in line with the business and risk strategy, objectives, values and long-term interests of the bank and incorporate measures to prevent conflicts of interests. Compensation programs should facilitate adherence to risk appetite, promote appropriate risk-taking behavior and encourage employees to act in the interest of the company as a whole (also taking into account client interests) rather than for themselves or only their business lines.

G. Practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain should be carefully evaluated by means of both qualitative and quantitative key indicators. Banks should ensure that variable compensation is adjusted to take into account the full range of current and potential risks an employee takes as well as realized risks, including breaches of internal procedures or legal requirements. Compensation should reflect risk-taking and risk outcomes.

Principle 12:

Disclosure and Transparency

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

A. Transparency is consistent with sound and effective corporate governance. It is difficult for shareholders, depositors, other relevant stakeholders and market participants to effectively monitor and properly hold the board and senior management accountable when there is insufficient transparency. The objective of transparency in the area of corporate governance is therefore to provide these parties with the information necessary to enable them to assess the effectiveness of the board and senior management in governing the bank.

B. Although disclosure may be less detailed for non-listed banks, especially those that are wholly owned, these banks can nevertheless pose the same types of risk to the financial system as publicly traded banks through various activities, including their participation in payment systems and acceptance of retail deposits.

C. All banks, even those for whom disclosure requirements may differ because they are non-listed, should disclose relevant and useful information that supports the key areas of corporate governance. Such disclosure should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank.

D. Disclosure should include, but not be limited to, material information on the bank's objectives, organizational and governance structures and policies (in particular the content of any corporate governance or remuneration code or policy and the process by which it is implemented), major share ownership and voting rights and related party transactions. Relevant banks should appropriately disclose their incentive and compensation policy. In particular, an annual report on compensation should be disclosed to the public. It should include: the decision-making process used to determine the bank-wide compensation policy; the most important design characteristics of the compensation system, including the criteria used for performance measurement and risk adjustment; and aggregate quantitative information on compensation.

E. The bank should also disclose key points concerning its risk exposures and risk management strategies without breaching necessary confidentiality. When involved in complex or non-transparent activities, the bank should disclose adequate information on their purpose, strategies, structures, and related risks and controls.

F. Disclosure should be accurate, clear and presented such that shareholders, depositors, other relevant stakeholders and market participants can consult the information easily. Timely public disclosure is desirable on a bank's public website, in its annual and periodic financial reports, or by other appropriate means. It is good practice to have an annual corporate governance-specific and comprehensive statement in a clearly identifiable section of the annual report depending on the applicable financial reporting framework. All material developments that arise between regular reports should be disclosed to the bank supervisor and relevant stakeholders as required by law without undue delay.

Principle 13:

The Role of Supervisors

Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

A. The board and senior management are primarily responsible for the governance of the bank, and shareholders and supervisors should hold them accountable for this.

<u>Guidance on Expectations for Sound Corporate Governance</u>

A. Supervisors should establish guidance or rules requiring banks to have robust corporate governance policies and practices. Such guidance is especially important where national laws, regulations, codes or listing requirements regarding corporate governance are too generic or not sufficient to address the unique corporate governance needs of banks. Regulatory guidance should address, among other things, expectations for checks and balances and a clear allocation of responsibilities, accountability and transparency among the board and senior management and within the bank. In addition to guidance or rules, where appropriate, supervisors should also share industry best practices regarding corporate governance with the banks they supervise.

Comprehensive Evaluations of a Bank's Corporate Governance

A. Supervisors should have processes in place to fully evaluate a bank's corporate governance. Such evaluations may be conducted through regular reviews of written materials and reports, interviews with board members and bank personnel, examinations, self-assessments by the bank, and other types of on- and off-site monitoring. The evaluations should also include regular communication with a bank's board of directors, senior management and those responsible for the risk, compliance and internal audit functions and external auditors.

B. Supervisors should evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their respective oversight responsibilities. Supervisors should evaluate whether the board and senior management have processes in place for the oversight of the bank's strategic objectives including risk appetite, financial performance, capital adequacy, capital planning, liquidity, risk profile and risk culture, controls, compensation practices, and the selection and evaluation of management. Supervisors should focus particular attention on the oversight of the risk management, compliance and internal audit functions. This should include assessing the extent to which the board interacts with and meets with representatives of these functions. Supervisors should determine whether internal controls are being adequately assessed and contribute to sound governance throughout the bank.

C. Supervisors should evaluate the processes and criteria used by banks in the selection of board members and senior management and, as they judge necessary, obtain information about the expertise and character of board members and senior management. The individual and collective suitability of board members and senior management should be subject to ongoing attention by supervisors.

D. As part of their evaluation of the overall corporate governance in a bank, supervisors should also endeavor to assess the governance effectiveness of the board and senior management, especially with respect to the risk culture of the bank. An assessment of governance effectiveness aims to determine the extent to which the board and senior management demonstrate effective behaviors that contribute to good governance. This includes consideration of the behavioral dynamic of the board and senior management, such as how the "tone at the top" and the cultural values of the bank are communicated and put into practice, how information flows to and from the board and senior management, and how potential serious problems are identified and addressed throughout the organization. The evaluation of governance effectiveness includes review of any board and management assessments, surveys and other information often used by banks in assessing their internal culture, as well as supervisory observations and qualitative judgments. In arriving at such judgments, supervisors need to be particularly mindful of consistency of treatment across the banks they supervise and ensure that staff has appropriate training and competence in these areas.

E. In reviewing corporate governance in the context of a group structure, supervisors should take into account the corporate governance responsibilities of both the parent company and subsidiaries.

Regular Interaction with Directors and Senior Management

A. Supervisors should interact regularly with boards of directors, individual board members, senior managers and those responsible for the risk management, compliance and internal audit functions. This should include scheduled meetings and ad hoc exchanges, through a variety of communication vehicles (e.g. e-mail, telephone, in-person meetings). The purpose of the interactions is to support timely and open dialogue between the bank and supervisors on a range of issues, including the bank's strategies, business model and risks, the effectiveness of corporate governance at the bank, the bank's culture, management issues and succession planning, compensation and incentives, and other supervisory concerns or expectations. Supervisors may also provide insights to the bank on its operations relative to its peers, market developments and emerging systemic risks.

B. The frequency of interactions with the above persons may vary according to the size, complexity, structure, economic significance and risk profile of the bank. On that basis, supervisors may, for example, meet with the full board of directors annually, but more frequently with the chairman or lead or senior independent director and with key committee chairs. For systemically important banks, interaction should occur more frequently, particularly with members of the board and members of senior management, and those responsible for risk management, compliance and internal audit functions.

Requiring Improvement and Remedial Action by a Bank

A. Supervisors should have a range of tools at their disposal to address governance improvement needs and governance failures. They should be able to require improvementsteps and remedial action, and assure accountability for the corporate governance of a bank. These tools may include the ability to compel changes in the bank's policies and practices, the composition of the board of directors or senior management, or other corrective actions. They should also include, where necessary, the authority to impose sanctions or other punitive measures. The choice of tool and the time frame for any remedial action should be proportionate to the level of risk the deficiency poses to the safety and soundness of the bank or the relevant financial system(s).

B. When a supervisor requires a bank to take remedial action, the supervisor should set a timetable for completion. Supervisors should have escalation procedures in place to require more stringent or accelerated remedial action in the event that a bank does not adequately address the deficiencies identified or the supervisor deems that further action is warranted.

Cooperation and Sharing of Corporate Governance Information with Other Supervisors

A. Cooperation and appropriate information-sharing among relevant public authorities, including bank supervisors, can significantly contribute to the effectiveness of these authorities in their respective roles. Such information-sharing is particularly important between home and host supervisors of cross-border banking entities. Cooperation can occur on a bilateral basis, in the form of a supervisory college or through periodic meetings among supervisors at which corporate governance matters should be discussed. Such communication can help supervisors improve their assessment of the overall governance of a bank and the risks it faces, particularly in a group context, and help other authorities assess the risks posed to the broader financial system. Information shared should be relevant for supervisory purposes and be provided within the constraints of confidentiality and other applicable laws. Special arrangements, such as a memorandum of understanding, may be warranted to govern the sharing of information among supervisors or between supervisors and other authorities.