

Expanding the Compliance
Monitoring Role to Support
the Implementation of
Corporate Governance
Improvement Programs in
Financial Institutions

THE PROACTIVE COMPLIANCE OFFICERS MANUAL



ADFIAP
financing sustainable development

Published by:
Association of Development Financing Institutions
in Asia and the Pacific



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Center for International Private Enterprise

The Association of Development Financing Institutions in Asia & the Pacific (ADFIAP) is the focal point of all development banks and other financial institutions engaged in the financing of development in the Asia-Pacific region. Its mission is to advance sustainable development through its members. Founded in 1976, ADFIAP has currently 70 member-institutions in 35 countries. The Asian Development Bank is a Special Member of the Association. ADFIAP is also a founding member of the World Federation of Development Financing Institutions composed of regional associations in Africa, Asia-Pacific, Latin America and the Middle East. ADFIAP is an NGO in consultative status with the United Nations' Economic and Social Council. The permanent Secretariat of ADFIAP is based in Makati City, Metro Manila, Philippines.

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IBC	VII A CD copy of the ADFIAP Corporate Governance Rating System (ACGRS) is at the inside back cover of this Manual (see pocket)

FOREWORD

This Proactive Compliance Officers Manual with the theme, "*Expanding the Compliance Monitoring Role to Support the Implementation of Corporate Governance Improvement Programs in Financial Institutions*" was prepared with two objectives in mind: (a) to develop a corps of Compliance Officers with a more proactive function of instituting corporate governance improvement programs in ADFIAP member-banks and (b) to encourage them to set up Compliance Units (CUs) in their respective institutions to sustain these efforts.

The Manual begins with a broad overview of the traditional mandate of bank compliance officers and why they are best suited to help out in the good governance improvement process within their institutions. A further elaboration ensues on the current available instruments for assessing and improving governance policies and processes, namely, the corporate governance code and the corporate governance 'scorecard'.

Next, the Manual highlights the four pillars of corporate governance, namely, the shareholders, the independent external auditor, the capital market and the judicial system, and how the interplay of these components leads to a robust and well-governed financial system. Afterwhich, the Manual covers in more details the ADFIAP Corporate Governance Rating System, which was benchmarked with the best practices worldwide, as a means to improve areas of corporate governance aspects internally in a financial institution, a CD copy of which is at the inside back cover of this Manual.

The Manual moves on to propose how a Compliance Unit can be set up and be operational within a financial institution, by giving examples of current regulations and practices of the Bank for International Settlements (BIS) and national central banks such as the Central Bank of the Philippines.

Finally, the Manual suggests an 'expanded' role of bank compliance officers to include assisting in corporate governance improvement programs in their institutions as well as a suggested short training program design for use in achieving the intended purpose of this Manual.

ADFIAP is ever grateful to the funding support of the Center for International Private Enterprise (CIPE) as well as to its insightful interaction with CIPE officers and staff, namely, its Executive Director, **Dr. John D. Sullivan**, its Senior Program Officer for Asia, **Mr. John Callebaut** and its Program Assistant, **Ms. Elizabeth Hallinan**. ADFIAP also conveys its appreciation to **Dr. Cesar G. Saldaña**, Founding Fellow of the Philippine Institute of Corporate Directors, who was the main and most valuable resource of this program. Lastly, ADFIAP thanks its member-banks which provided the much-needed local logistics for the conduct of training workshops in their areas as well as to the many participants who attended and shared their expertise and experience on the subject.

BACKGROUND INFORMATION

The development of this Proactive Compliance Officer Manual was part and parcel of Phase III of ADFIAP's "*DFIs for Corporate Governance*" Project entitled, "Compliance Officership Program: Institutionalizing Corporate Governance Improvement Practices in Development Banks in Asia and the Pacific".

The Compliance Officership Program (COP) is a 12-month capacity-building program for member-development banks of ADFIAP that aims to enhance good corporate governance practices in their respective organizations. The Compliance Officer (CO) was deemed as the focal person of the corporate governance improvement programs of the bank.

The project entailed the implementation of the following activities:

- One (1) regional workshop to equip the COs with new tools and best practices on the subject and to allow for an exchange of experiences among participating member-banks.
- Four (4) national workshops to adapt the above regional experience into a more homogenous and 'local' context.
- Publication of a Compliance Officers manual.

The regional training event was held in Manila, Philippines on December 12-16, 2005 with 17 participants from as many countries attending. It was followed by a national workshop in Hyderabad, India on February 2-4, 2006. Seventeen participants from various Indian financial institutions benefited from the event. ADFIAP collaborated with the Jawaharlal Nehru Institute for Development Banking (JINDB) in organizing this program.

The India event was followed by a workshop in Palau Islands in the Pacific on May 19, 2006. This event was organized in collaboration with the Association of Development Financing Institutions in the Pacific (ADFIP) and hosted by the Development Bank of Palau, a member of both ADFIAP and ADFIP. The seminar was attended by 18 participants from different financial institutions in the Pacific Islands.

The third workshop was held in Siem Reap, Cambodia on July 3-4, 2006 in collaboration with the Rural Development Bank of Cambodia, an ADFIAP member. Thirty three participants from development banks, commercial banks, central bank and microfinance institutions attended the program.

The last training event was held in Kota Kinabalu in Sabah, Malaysia from July 25-26, 2006 in cooperation with the Sabah Credit Corporation, an ADFIAP member. Fifty Malaysian participants attended this program.

The Compliance Monitoring Role To Support Implementation of Corporate Governance Improvement Programs

1. Overview: The Role of the Compliance Officer in Improving Governance in Financial Institutions

A global movement for improving corporate governance came as a result of corporate scandals in the U.S. and the Asian financial crisis. Governments began to set up new structures of supervision of companies. New legislations mandated accountability for corporate acts and decisions. Regulators expanded their review of companies¹ and financial institutions. The Compliance Officer's function has taken an important dimension in this setting.

The objective of this Manual is to support a more pro-active role for the Compliance Officer in helping the company implement governance improvement programs. The company determines the direction, priorities and timetable for its governance improvement programs. It is the Compliance Officer's role to assist in implementing the program. The Compliance Officer has the skills and knowledge base to understand the external review of the company.

2. Instruments for Assessing and Improving Governance Policies and Processes

The board of directors is the appropriate body that will determine the priorities for improvement of governance in the company. To support this process, the board of directors needs a reference point or standard for measuring its current governance practices. These standards are essentially contained in the *Code of Governance* of the country as endorsed for adoption by the regulatory authorities. To assist in determining how far the company lags behind in a governance area, one needs to measure its current practices against the standard. A way of measuring the steps for improving governance policies and practices is the *Corporate Governance Scorecard*.

¹ Corporate governance issues apply to private- and state-owned institutions as well as to non-government institutions. These entities are referred to here as "companies" but they apply as well to other types of institutions like state enterprises, banks and financial institutions and NGOs.

a. The Code of Governance

What is a Code of Governance? It is a set of governance policies, procedures and practices that are considered generally sound across a range of companies throughout a country or regions. Many governments of countries have formulated their own versions, adopted the Code and prescribed their adoption by companies. Others have simply adopted the general and globally-accepted codes like the OECD Code of Governance. By adopting a Code of Governance, the country is giving a signal that it is taking a pro-active stance in encouraging adoption of good governance policies and practices by companies and other types of corporate institutions in the country. There are various forms for encouraging compliance with the Code, namely: optional compliance policy, also called "comply or disclose" and direct regulations or mandatory compliance policy.

i. "Comply or Disclose" Policy

Some countries consider a regulatory approach as inappropriate for influencing the governance policies and practices of their corporate sectors. They note the heavy enforcement burden that the regulatory approach would entail. Instead of direct regulation, these countries rely on the capital market to discipline the companies into adopting sound governance practices.

How can capital market discipline help in the adoption of sound governance principles? Basically, this approach requires the government to inform companies of their adoption of the Code of Governance and then requesting them and other corporate institutions to adopt the Code on a voluntary basis. As part of its reports to a body like the Securities and Exchange Commission (SEC), a company is required to disclose whether it complies with the Code. If it does not, the company is required to identify what provision of the Code has not been adopted and to explain why. Public disclosure of the explanation will be known to capital market analysts who will then pass judgment on whether the deviation from the Code damages their investments or not. If it does, market analysts recommend to investors that shares of stocks of the company be discounted due to this factor. Creditors who consider non-compliance as increasing their credit risk can set up risk control mechanisms that will make loans more costly to the company.

ii. Direct Regulation Policy

Sometimes the stakes are too high for the government and regulatory institutions to allow companies to adopt good governance practices on a

voluntary basis. The stock exchanges and the SEC are examples of regulators. They have the enforcement mechanisms. Allowing badly-governed companies to trade in the stock exchanges and the non-listed ones to raise money from the public and banks, exposes investors and lenders to high risks. If there are many such companies that are traded in the stock exchanges or borrowing money from the public, there could be system-wide failures. For these reasons, stock exchanges, SEC and the Central Bank require adoption of specific good governance practices. In some cases, new laws are passed on good governance that are implemented by government institutions like SEC, Central Bank and Capital Market Commission and private institutions like the stock exchanges.

Examples of laws and regulations passed in various countries in Asia and the Pacific in the last decade are:

- appointment of a minimum number (or percentage) of independent directors in the board
- a "fit-and-proper rule" for directors of banks
- rotation (replacement) of independent auditors within a maximum of 5 years
- mandating the creation and operation of board committees like the Audit Committee and the Risk Management Committee
- certification by the CEO and CFO of responsibility for the completeness and accuracy of information in the financial statements

b. The ADFIAP Corporate Governance Rating System

Codes of governance present the criteria for good governance policies and practices that every corporate entity should follow. Most companies have not yet achieved those desired states. In short, their governance practices need improvement. To this end, a company needs an instrument for assessing and determining its current state of governance. An assessment instrument that has been designed for member institutions of ADFIAP is the "Corporate Governance Rating System," (a CD copy in the back inside cover of this Manual, is in two versions: for state-owned development finance institutions [DFI] and for privately-owned financial institutions [FI]). The instrument is suitable for assessing the degree of voluntary adoption of sound governance practices classified by different aspects of governance. By using the assessment tool, a company will be able to determine the areas for improvement and track the progress of those improvements in the future.

The ADFIAP corporate governance scorecard is a suitable internal compliance instrument, with the priorities, targets and guidelines set internally by the management and the board of directors and, externally, the compliance requirements of government regulators. The latter is best addressed by a Compliance Officer conducting his/her own due diligent assessment of actual regulatory compliance.

3. Areas for Improvement in Corporate Governance

The agenda for corporate governance improvement depends on the country, companies and institutions. Basically, corporate governance depends on the social culture of the country and the strength of institutions supporting the corporate processes.

a. The 4 Pillars of Corporate Governance

There are four pillars of corporate governance, each representing a set of institutions that promote good governance, as follows:

- **Shareholders.** The power of shareholders manifests itself in the annual shareholder's meeting when they make collective decisions on the business of the company. For state-owned institutions, that power rests on only one shareholder. How shareholders exercise their ultimate authority will determine the governance processes of the company. A vigilant shareholder will ensure that sound governance processes are in place. They will require fairness, accountability and transparency in all business dealings of the company. Shareholders, whether individuals, companies or the State, who do not exercise their ultimate rights will tend to allow weaknesses in governance. This results in higher risks of mismanagement, misappropriation of shareholder resources, regulatory sanctions, and disservice to stakeholders and the public.
- **Independent external auditors.** Performance of the external audit function involves a direct test of whether the financial statements, an accountability of management, present fairly and transparently the true condition and performance of the company. Reliable and fairly-presented results of operations will encourage management to perform well and deter controlling shareholders from taking advantage of smaller shareholders.
- **The capital market.** Analysts and investors act as guardians of shareholder value. They determine if management serves the interest of shareholders and convert them to value for all shareholders. If there are governance

problems, they are one of the first to be aware and they respond with downgrades of the concerned listed companies. They value well-governed companies higher, knowing that eventually this value will go to all shareholders.

- **The judicial system.** If all means of preserving and getting the value of their investments have not worked, a shareholder has to rely on the justice system to enforce his/her/its rights. The shareholder's basic right to exit the company and get a fair value for his/her/its shares is guaranteed by the Company Law. Shareholders can also prosecute erring managers and shareholders who misappropriate the wealth of other shareholders. A strong justice system deters the commitment of corporate crimes and encourages investors, knowing that they are protected under the law.

b. Ensuring Compliance with Corporate Governance Regulations and Standards

A first order of business of a company is ensuring its compliance with regulations. This rule applies as well to corporate governance regulations of the country. As earlier stated, the prevailing regulatory framework for corporate governance depends on the country, although trade across countries and globalization tend to homogenize the regulation of companies across countries.

Compliance with the corporate governance regulations and standards require addressing the two types of regulations stated earlier, namely the "comply or disclose rule" and direct regulation. Under the former, deviations from prescribed governance rules are allowed so long as the company makes the appropriate public disclosure. Whether it constitutes a serious damage on the credibility of management and shareholder value will depend on the judgment of investors in the capital market. For this reason, this type of regulation is applicable to publicly-listed companies.

Where there are specific laws and regulations, compliance involves actually performing or setting up the required structures. As identified earlier, the requirements are as stated in the country's regulations like the requirement for independent directors, rotation of external auditors, setting up of committees at the board of directors, certification of financial statements, etc.

c. Improving the Company's Conduct of Corporate Governance

Aside from meeting regulatory requirements, a company's long-term growth must be supported by strong internal governance structures. Improvements come from internal changes, voluntarily undertaken by the board of directors and management to serve shareholders and stakeholders. Specific improvements are generated from programs that are set with clear goals, resources and timetable. In many cases, the board of directors implements the program directly, with the assistance of management. That approach generates a problem of lack of independence of management in aspects of improvement programs that involve, or can affect management. In such cases, the board of directors can call for the assistance of the Internal Auditor or the Compliance Officer, depending on the nature of the improvement project. These two functions have the requisite independence and skills to assist the board of directors in certain governance improvement projects.

The agenda of a possible governance improvement program is generated by the board of directors, or upon its initiative. For financial institutions, a formal assessment instrument, like the ADFIAP Corporate Governance Rating System, prepared based on OECD Principles and adapted to Asia-Pacific conditions, could be used by the company's board of directors to develop such an agenda. From Annex I and a CD copy provided with this Manual, the governance improvement agenda could focus on the following major areas, with action areas indicated, as follows:

i. Stakeholders and Beneficiaries for State-Owned Development Finance Institutions (DFI)

- Identification of stakeholders or beneficiaries of the DFI
- Closer linkages of the DFI's investments and credit programs closely linked to development plans for the beneficiaries
- Involvement of the board in preparation of investments and credit programs
- Inclusion in the annual report of the DFI of a Management Discussion & Analysis (MD & A) on the impact of its services to its stakeholders and its beneficiaries
- Degree of access of stakeholders and beneficiaries to information and capacity to express their opinion on DFI performance
- Whether the supervising ministry of the DFI set performance targets for it in terms of profits and services

Shareholders for Privately-owned Financial Institutions

- Equality of rights of shareholders
- Degree of encouragement of shareholders to attend the annual shareholders' meeting
- Due consultations and information to stakeholders
- Reliability, relevance and timeliness of information to shareholders

ii. The Board of Directors

- Involvement of the Chairman in setting the agenda for the Board meeting
- Degree of participation by members of the board during the meeting
- Separation of the board from management
- Process of selection of directors: fit and proper?
- Diversity of background and experience of individual directors
- Frequency of board meetings
- Attendance of directors in board meetings
- Number of concurrent directorships held by each director

iii. Commitment to Improvements in Governance

- Whether the company has a written Code of Governance
- Whether the company has a Management Discussion and Analysis to accompany its annual report
- Whether the company has a Compliance Officer with specific roles, independent reporting to the board of directors and access to relevant information
- Whether the company has a Code of Ethics that a director signs in upon appointment to the board

iv. External Audit

- Reputation as to independence and quality of external auditors
- Creation of an Audit Committee of the Board that review the work of external auditors and to recommend appointment of external auditors
- Proper qualifications of members of the Audit Committee as to financial skills and experience and independent directors according to regulations, if relevant regulations exist
- Publication of the audited financial statements within three months from end of business year.

v. Disclosures

- Whether the MD & A of the company discusses issues that are relevant to shareholder value and other details of operations
- The extent that the company's annual report discusses its risk management system and its major risk factors
- Whether the annual report offers meaningful details like portfolio composition, business segment performance, potential liabilities, in conformity with International Financial Reporting Standards, etc.
- Whether transactions with related parties are disclosed through an established mechanism, approved by regulators and the central bank (or its equivalent institution)

4. Current Regulations and Practices in Establishing and Operating a Compliance Unit

The creation of a Compliance Unit and performance of compliance review have precedence in both international regulations and voluntary practice. Both Bank for International Settlements (BIS) and country central banks have issued guidelines and regulatory measures, respectively, to enforce performance of compliance reviews. The provisions of BIS and central bank (example of the Philippine Central Bank is used here) are summarized below.

a. Compliance Function at the Bank for International Settlements

On May 9, 2005, the Bank of International Settlements in Basel, Switzerland adopted a Charter for its own Compliance Unit, shown as Annex II. The provisions of the charter specify the responsibilities of units for compliance, the roles and responsibilities for the Compliance Unit, and the independence and accountability of the Compliance Unit of the BIS. The Charter serves as a model for banks with its provisions as summarized below:

i. Responsibilities for Compliance by Different Units

Compliance responsibilities are shared among all staff members as well as across various units of the BIS:

- Management and line managers have primary responsibility for compliance.
- The Compliance Unit identifies and assesses compliance risks, guides and educates staff on compliance issues, performs a monitoring and reporting role and in cooperation with the Legal Service also an advisory role.
- The Legal Service has primary responsibility for identifying the relevant laws, rules and standards with which the BIS should comply.
- Risk Control monitors the BIS' financial risks (credit risk, market risk and liquidity risk) and ensures compliance with the respective policies and limits.
- Internal Audit reviews the adequacy of controls established to ensure compliance with policies, plans, procedures and business objectives.

ii. Roles and Responsibilities of the Compliance Unit

The role of the Compliance Unit is to assist management to ensure on a reasonable basis that BIS-wide activities are conducted in conformity with applicable laws and regulations, the BIS' Code of Conduct and all relevant rules and policies. The Compliance Unit's responsibilities are:

- identify, document and assess compliance risks associated with the BIS' activities;

- assess the appropriateness of the BIS' compliance procedures and guidelines;
- promptly follow up any identified deficiencies and, where necessary, formulate proposals for amendments;
- in cooperation with the Legal Service and relevant business units, provide guidance and advice to staff on the appropriate implementation of the relevant laws, rules and standards through internal policies and procedures;
- assist Management and line managers in educating staff on compliance issues;
- act as a contact point within the BIS for compliance queries from staff members;
- monitor compliance by performing sufficient and representative compliance risk assessment and testing;
- conduct spot checks for compliance with policies and procedures, making enquiries into deficiencies and/or breaches, and carrying out investigations.

iii. Head of Compliance Unit

The Head of Compliance Unit shall report on a regular basis to his/her line manager on compliance risk assessment and testing during the reporting period, summarize any material deficiencies and/or breaches and recommend measures to address them, and report on the corrective measures already taken; in addition to this regular reporting, the Head of Compliance should report any deficiency or breach of which he/she becomes aware to the appropriate level of Management in accordance with prudent materiality criteria.

iv. Independence and Accountability of the Compliance Unit

The Compliance Unit is independent from the business activities of the BIS and is managed by the Head who reports directly to the Deputy General Manager. The Head of Compliance shall not be placed in a position where there is a possible conflict of interest between compliance

responsibilities and any other responsibilities. Staff members who have responsibilities other than solely for the Compliance Unit should report directly to the Head of Compliance on compliance issues.

b. Establishing the Compliance Unit Under Guidelines from a Central Bank

The central bank of the country may adopt policies and guidelines for installing a Compliance Unit for banks. Other financial institutions, i.e., non-banks, can adopt the same measures and guidelines. For example, in the Philippines, the Central Bank defined and justified the setting up of Compliance Officer position as shown in several circulars in Annex III. Key guidelines defining the compliance system, the Compliance Officer's position, the role of the board and management are summarized as follows:

i. Compliance System

The compliance system consists the following: a written compliance program approved by the Bank's board of directors, a constructive working relationship with regulatory agencies, an open communication process within the bank to address compliance matters, and regular monitoring and assessment of the compliance program.

ii. Compliance Risk

Compliance risk is the risk of legal or regulatory sanctions, financial loss, or loss to reputation a bank/non-bank may suffer because of failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice.

iii. Compliance Officer

The principal function of the compliance officer is to oversee and coordinate the implementation of the compliance system including the identification, monitoring and controlling of compliance risks. He shall have a rank of at least a Vice President and should have the skills and expertise to provide appropriate guidance and direction to the bank on the development, implementation and maintenance of the compliance program. An independent full-time compliance officer shall be appointed by every commercial bank. For other types of banks, an incumbent senior officer may be designated concurrently as the bank's compliance officer, provided, such designation will not give rise to any conflict of

interest situation. The internal auditor of a bank may be designated as its compliance officer as long as the primary duty is that of a compliance officer.

iv. Responsibilities of the Board of Directors and Senior Management in Compliance

The board of directors should oversee the implementation of the compliance policy. Senior management should be responsible for establishing a compliance policy, ensuring that it is observed, reporting to the board of directors on its ongoing implementation and assessing its effectiveness and appropriateness. They should report to the board of directors on compliance policy and its implementation. The Compliance Unit should be organized under a charter approved by the board of directors. The charter defines the compliance function's standing, authority and independence.

5. Expanding the Role of the Compliance Unit to Include Assisting in Corporate Governance Improvement Programs

The previous sections established that the compliance function has taken an important role in long-term stability of the financial system. The challenge is how to integrate the governance review into the existing functions of the Compliance Unit. There would be many differences across countries on how this can be done. This Manual will suggest the important milestones in that direction.

a. Guidelines on How to Organize the Compliance Unit

Central banks and the BIS provide guidance on how to organize the Compliance Unit whose functions and responsibilities can be made to include assessing compliance with codes of governance and improvement projects.

i. The Charter of the BIS Compliance Unit

For the BIS' own Compliance Unit, the main characteristics that support an expansion of its Compliance Unit are as follows:

- *Pro-active approach* in identifying compliance risks. Potential non-compliance with governance regulations need to be corrected early

because it usually takes time to introduce improvement in governance structures and processes.

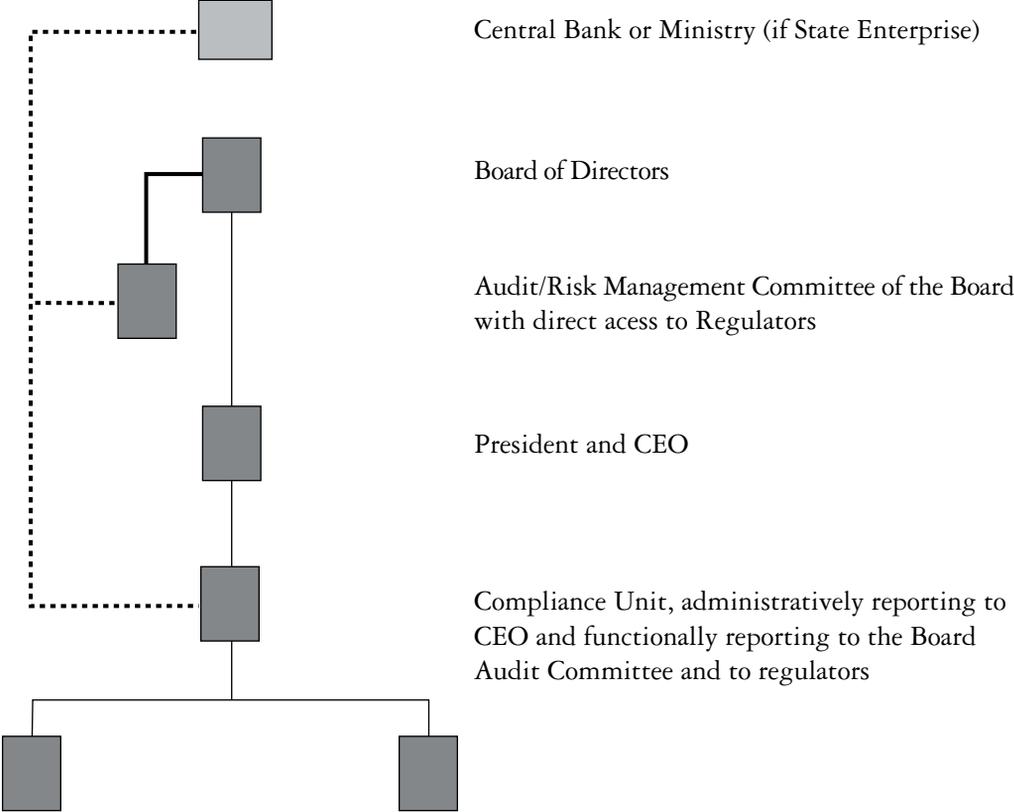
- *Access to records* and documents and capacity to require other units to report on matters related to governance.
- *Independence* from other activities of the bank. Using the BIS model, the Compliance Officer (Head of Unit) will be reporting to the president/CEO on compliance with rules and regulations and to the Board if the functions of the Compliance Unit are expanded into governance compliance monitoring.

ii. Central Bank Guidelines Suitable for Compliance Unit with an Expanded Mandate to Include Compliance with Governance Regulations

- a written compliance program for the Compliance Unit, approved by the board of directors, that identifies the relevant laws and regulations including those regarding governance
- consultations by the Compliance Unit with the regulatory agencies on specific provisions of laws and regulations related to governance and/or discuss compliance findings with the Board and regulatory authorities.
- Regular monitoring and assessment of the effectiveness of the compliance program, i.e., whether corrective measures are undertaken on exceptions noted by the Compliance Unit.

b. Organization Chart for the Compliance Unit with Expanded Governance Function

COMPLIANCE UNIT FUNCTIONAL ORGANIZATION



The organization chart shows that the Compliance Unit has a reporting relationship with both: a) the Board through the Audit or Risk Management Committee and b) the central bank or supervising ministry if it is a State enterprise. Access by the Compliance Unit to the highest level in the organization and to external agencies makes it effective as a body that will assist the Board and management in pursuing improvements in governance.

c. Functions and Responsibilities of the Compliance Unit related to Corporate Governance

i. The BIS Compliance Unit as a Model for Expanding into Governance Compliance

At the BIS, the role of its Compliance Unit is to assist its management to ensure that the bank-wide activities of the BIS and its staff are conducted in conformity with applicable laws and regulations, the BIS Statutes, the Bank's Code of Conduct and all relevant rules and policies, and generally with sound practices pertinent to those activities.

The functions and responsibilities of a Compliance Unit can be expanded to include reviewing and ensuring compliance with governance rules and practices, for example:

- identify document and assesses compliance with provisions on the Code of Governance of the country and the company;
- assess the appropriateness of the Board's compliance procedures and guidelines,
- promptly follow-up any identified deficiencies in compliance with the Code of Governance and sound governance practices and, where necessary, formulate proposals for amendments;
- assist in educating the Board and management on the provisions of the code and sound governance practices

ii. Expanding Central Bank's Compliance Function to Include Compliance with Governance Regulations

The functions and responsibilities for Compliance Units required by central banks can also be enriched with assistance in improving corporate governance in the following ways:

- to oversee and coordinate the implementation of a compliance system that has been expanded to include compliance with the Code of Governance and sound governance practice.

- identification, monitoring and controlling of compliance with the Code of Governance and governance improvement initiatives of the company.

6. Corporate Governance Orientation and Short Training Course for the Compliance Unit

To enable the Compliance Unit to expand their compliance checks into corporate governance, the Compliance Officer and staff of the Compliance Unit should undergo an orientation on corporate governance principles and practices. In many countries, the central bank and association of corporate directors endorse, sponsor and undertake orientation and training courses on the subject.

This Manual presents a few elements of the training course and suitable as basic material for such a course, as follows:

a. Principles of Corporate Governance

Training Objective: To review the fundamental principles of corporate governance and the pre-requisites for good governance

Training Materials: Annex IV (Suggested Powerpoint presentation notes on "*Overview of Principles of Corporate Governance*")

b. Overview of Corporate Governance Rating System

Training Objective: To understand the areas in corporate governance that will be the focus of regulatory requirements on minimum standards of governance structures and the focus of compliance review.

Training Materials:

- CD copy on the "*ADFIAP Corporate Governance Rating System*"
- Annex I (Powerpoint presentation notes on "*Overview of Rating System in Corporate Governance*")

c. Organization, Functions and Responsibilities of the Corporate Governance Unit

Training Objective: To understand the requirements for a functional Compliance Unit and to determine the functions and responsibilities that are related to assessing compliance in corporate governance regulations and sound practices.

Training Materials:

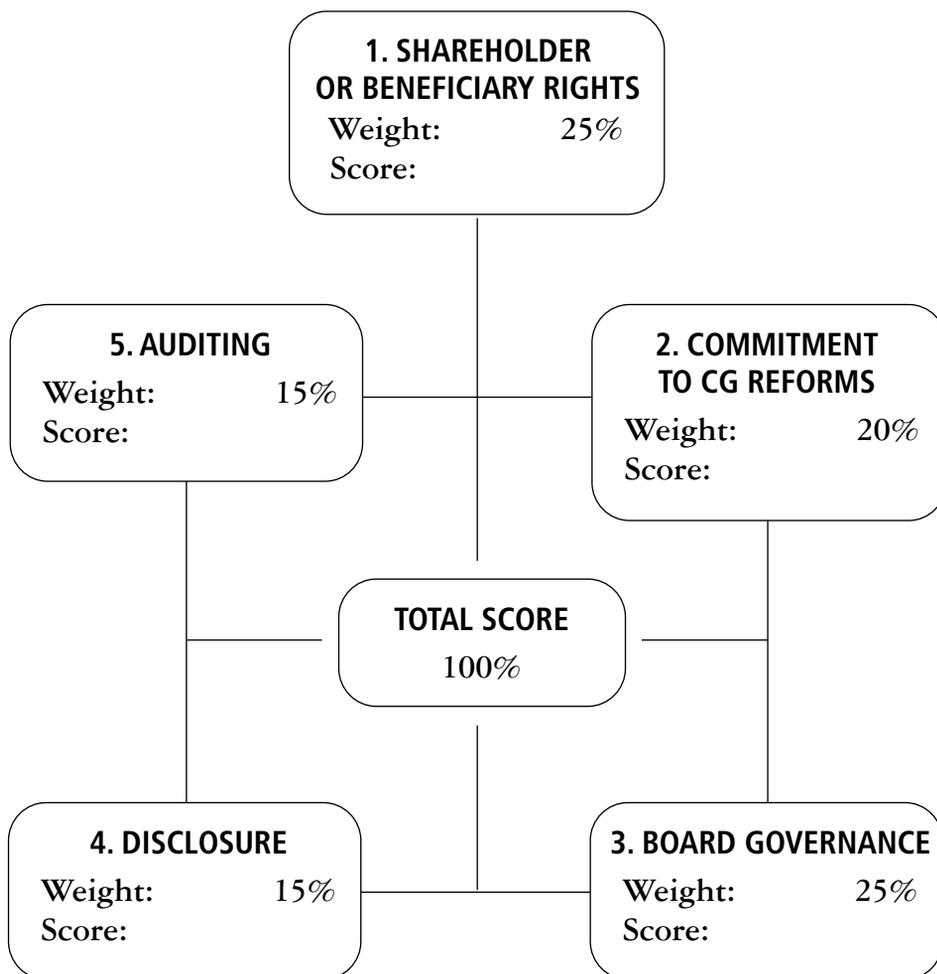
- Annex II: "*BIS Compliance Charter*"
- Annex V: (*Compliance System Updates* – Suggested Powerpoint presentation notes on various regulations and guidance from the Philippine Central Bank on Compliance Officer/Unit)
- Annex VI: Case studies of findings from a compliance review and results in Philippine banks

ANNEX I

OVERVIEW OF THE ADFIAP CORPORATE GOVERNANCE RATING SYSTEM

(Suggested Powerpoint Presentation Notes)

*(Rating Criteria and Areas for Improvement of
Corporate Governance Systems of Financial Institutions)*



Pillars of Good Corporate Governance

- *Shareholder Rights*
- *Commitment to Corporate Governance Principles*
- *Board Governance*
- *Transparency & Disclosure*
- *Auditing*

1. Stakeholder & Shareholder Rights

- fair treatment to all shareholders and attention to other stakeholders
- access to information by stakeholders
- control of the company in proportion to shareholdings
- right to seek compensation for any act of expropriation of the company's wealth by dominant shareholders
- for DFIs, assistance to specified sectors in society and economy

2. Commitment to Corporate Governance Principles

- comply with norms of social, environmental and public welfare
- management to work in the best interest of shareholders
- enhance long-term shareholder value (not easily accepted in regions like Asia where capital markets are underdeveloped and companies are family-held)

3. Board Governance

- the Board of Directors to assume effective governance over the company
- accountability of the Board to shareholders and to regulatory authorities
- sound policies and practices in selecting directors

- appointment of independent directors
- adherence to sound practices by the Board of Directors

4. Transparency & Disclosure

- equal access to information by shareholders
- investors can get information on current condition of the corporation
- management analysis of financial results
- reports for annual shareholders' meetings
- full disclosure of inter-company and related party transactions.

5. Auditing

- follow generally accepted accounting standards for its financial reporting
- audited by professionally competent independent external auditors.

ANNEX II

BANK FOR INTERNATIONAL SETTLEMENTS COMPLIANCE CHARTER

I. Introduction

This Charter describes the basic principles for promoting sound compliance practices at the Bank for International Settlements. The Charter demonstrates the Bank's commitment to excellence in performance and the highest ethical standards, as well as adherence to applicable legal and regulatory requirements and professional standards.

II. Responsibilities for Compliance

Compliance responsibilities are shared among all staff members as well as across various units of the Bank, the most notable of which are following:

- Management and line managers have primary responsibility for compliance at the Bank.
- The Compliance Unit identifies and assesses compliance risk, guides and educates staff on compliance issues, performs a monitoring and reporting role and in cooperation with Legal Service also an advisory role (see part IV. A).
- The Legal Service has primary responsibility for identifying the relevant laws, rules and standards with which the Bank should comply and for providing interpretation in case of doubt.
- Risk Control monitors the Bank's financial risks (credit risk, market risk and liquidity risk) and ensures compliance with the respective policies and limits.
- Internal Audit reviews the adequacy of controls established to ensure compliance with policies, plans, procedures and business objectives, in accordance with the Internal Audit Charter.

III. Compliance Committee

A Compliance Committee has been established to ensure that important compliance issues are coordinated and communicated throughout the Bank. The Compliance Committee's responsibilities are to determine priorities for the Compliance Unit and approve a compliance programme on the basis of a proposal from the Head of Compliance. In so doing, the Compliance Committee ensures coordination of the Compliance Unit's activities with the Legal Service, Risk Control, Internal Audit and other units involved in compliance at the Bank. The Compliance Committee also serves as the vehicle for informing and advising the Bank's Executive Committee on material compliance matters.

The Committee is chaired by the Deputy General Manager. Its other members are the Head of Compliance, the respective Heads of the Legal Service, Risk Control and Internal Audit, and one senior staff member from each of the Monetary and Economic Department, the General Secretariat and the Banking Department. The Committee may invite at any time other members of Management or staff to discuss special topics when necessary. The Head of Compliance acts as the Secretary to the Committee.

The Committee meets at a minimum four times a year. Any member of the Committee may call for an extraordinary meeting, with the prior approval of the Deputy General Manager.

IV. The Compliance Unit

The role of the Compliance Unit is to assist Management to ensure on a reasonable basis that the bank-wide activities of the BIS and its staff are conducted in conformity with applicable laws and regulations, the BIS Statutes, the Bank's Code of Conduct and all relevant rules and policies, and generally with sound practices pertinent to those activities.

A. Specific responsibilities of the Compliance Unit

The Compliance Unit shall have the following specific responsibilities:

- on a pro-active basis, identify, document and assess compliance risk associated with the Bank's activities;
- assess the appropriateness of the Bank's compliance procedures and guidelines, promptly follow-up any identified deficiencies and, where necessary, formulate proposals for amendments;

- in cooperation with the Legal Service and relevant business units, provide guidance and advice to staff on the appropriate implementation of the relevant laws, rules and standards through internal policies and procedures;
- assist Management and line managers in educating staff on compliance issues, and act as a contact point within the Bank for compliance queries from staff members; and
- monitor compliance by performing sufficient and representative compliance risk assessment and testing - this includes performing spot checks to test compliance with policies and procedures, making enquiries into deficiencies and/or breaches, and carrying out investigations.

The Head of Compliance shall report on a regular basis to his/her line manager on compliance matters - the reports should refer to the compliance risk assessment and testing that has taken place during the reporting period, summarize any material deficiencies and/or breaches and recommend measures to address them, and report on the corrective measures already taken; in addition to this regular reporting, the Head of Compliance should report any deficiency or breach of which he/she becomes aware to the appropriate level of Management in accordance with the materiality criteria to be approved by the Compliance Committee.

B. Independence and Accountability

The Compliance Unit is independent from the business activities of the Bank and is managed by the Head of Compliance. The Head of Compliance reports directly to the Deputy General Manager.

The Head of Compliance and Compliance Unit staff shall not be placed in a position where there is a possible conflict of interest between their compliance responsibilities and any other responsibilities they may have. Staff members who have responsibilities other than solely for the Compliance Unit (e.g., staff with designated compliance responsibilities in the Bank's Representative Offices), should report directly to the Head of Compliance on compliance issues.

In addition to the reporting referred to in the last paragraph of Section A above, the Head of Compliance shall submit an annual report to the Compliance Committee, the General Manager, and the Audit Committee of the Board of Directors on the activities of the Compliance Unit. The Head of Compliance shall meet with the Audit Committee at least once a year and shall also have the right of direct access to the Audit Committee.

C. Authority

To carry out its mission effectively, the Compliance Unit in the course of its activities shall be authorized to:

- 1) Enter all areas of the Bank and have access to any documents and records considered necessary for the performance of its responsibilities; and
- 2) Require all members of Management and staff to supply such information and explanations as may be needed within a reasonable period of time.

D. Standards

The Compliance Unit shall keep abreast of sound practices in its field and in particular take into account the recommendations of the Basel Committee on Banking Supervision on compliance-related issues.

V. Relationship among Bank Units

In addition to the specific collaboration through the Compliance Committee, on an ongoing basis efforts shall be made to ensure good coordination and close and continued cooperation between the Compliance Unit and other units, in particular the Legal Service, Risk Control and Internal Audit.

The Compliance Unit shall seek legal and interpretative advice from the legal Service, in particular through regular bilateral meetings. As necessary, the Legal Service may arrange for consultation with external experts. The Legal Service retains primary responsibility for relations with public authorities and involved in responding to external compliance-related inquiries.

To the same extent as other units of the Bank, the Compliance Unit is subject to periodic review by the Internal Audit.

VI. Implementation

This Charter has been approved by the resolution no. 5176 (9 May 2005) of the Board of Directors.

ANNEX III

GUIDELINES FROM THE CENTRAL BANK ON ESTABLISHING A COMPLIANCE UNIT

PHILIPPINE CENTRAL BANK
CIRCULAR NO. 145
SERIES OF 1997

Section 1. Compliance System

The compliance system shall have the following basic elements:

- 1) *A written compliance program approved by the Bank's Board of Directors* – the program should enable the bank to identify the relevant Philippine laws and regulations, provide for periodic compliance testing with applicable legal and regulatory requirements, establish the responsibilities and duties of the compliance officer and other personnel (if any) involved in the compliance function, shall be submitted to the appropriate supervising and examining department of the Central Bank within twenty (20) banking days from the date of approval, and should be updated at least annually to incorporate changes in laws and regulations.
- 2) *A constructive working relationship with regulatory agencies* – the bank, through its compliance officer, may consult the regulatory agencies for additional clarification on specific provisions of laws and regulations and/or discuss compliance findings with the regulatory authorities.
- 3) *A clear and open communication process within the bank to educate and address compliance matters* – officers and staff must be trained on the regulatory requirements through regular meetings, distribution of manuals, and dissemination of regular issuances.
- 4) *Continuous monitoring and assessment of the compliance program* – the program should provide the periodic review of the compliance function to measure its effectiveness.

Section 2. Compliance Officer

The principal function of the compliance officer is to oversee and coordinate the implementation of the compliance system. His responsibility shall include the identification, monitoring and controlling of compliance risk. An independent full-time compliance officer shall be appointed by every commercial bank. His designation shall require prior approval of the Monetary Board. He shall have a rank of at least a Vice President and should have the skills and expertise to provide appropriate guidance and direction to the bank on the development, implementation and maintenance of the compliance program. For other types of bank, an incumbent senior officer may be designated concurrently as the bank's compliance officer, provided, such designation will not give rise to any conflict of interest situation. Also, the internal auditor of a bank may be designated as its compliance officer subject to the condition that his primary duty will be to act as compliance officer.

PHILIPPINE CENTRAL BANK CIRCULAR NO. 429 SERIES OF 2004

Section 1. Compliance risk

Compliance risk is the risk of legal or regulatory sanctions, financial loss, or loss to reputation a bank/ non-bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice.

Section 2. Responsibilities of the board of directors and senior management on compliance

The board of directors should oversee the implementation of the compliance policy and ensure that compliance issues are resolved expeditiously. On the other hand, senior management should be responsible for establishing a compliance policy, ensuring that it is observed, reporting to the board of directors on its ongoing implementation and assessing its effectiveness and appropriateness. They should, at least once a year, report to the board of directors or a committee of the board on matters relevant to the compliance policy and its implementation, recommending any required changes to the policy. The report should assist the board members in making an informed assessment as to whether the institution is managing its compliance risk effectively. However, any material breaches of laws rules and standards shall be reported promptly.

Section 3. Status

The compliance function should have a formal status within the organization established by a charter or other formal document approved by the board of directors that defines the compliance function's standing, authority and independence, and addresses the following issues:

1. measures to ensure the independence of the compliance function from the business activities of the bank;
2. its role and responsibilities;
3. its relationship with other functions or units within the organization;
4. its right to obtain access to information necessary to carry out its responsibilities;
5. its right to conduct investigation of possible breaches of the compliance policy;
6. its formal reporting relationships to senior management and the board of directors; and
7. its right of direct access to the board of directors or an appropriate committee of the board.

The compliance charter or other formal document defining the status of the compliance function shall be communicated throughout the organization.

Section 4. Independence

The compliance function should be independent from the business activities of the institution. It should be able to carry out its responsibilities on its own initiative in all units or departments where compliance risk exists and must be provided with sufficient resources to carry out its responsibilities effectively. It must be free to report to senior management and the board or a committee of the board on any irregularities or breaches of laws, and standards discovered, without fear of retaliation or disfavor from management or other affected parties. The compliance function should have access to all operational areas as well as any records or files necessary to enable it to carry out its duties and responsibilities.

Section 5. Role and responsibilities of the compliance function

The role and responsibilities of the compliance function should be clearly defined. If there is a division of duties and responsibilities between different functions such as legal, compliance, internal audit or risk management, the allocation of duties and responsibilities to each function should be properly delineated. There should likewise be formal arrangement for cooperation between each function and for the exchange of relevant information.

Section 6. Cross-border issues

The compliance function for institutions that conduct business in other jurisdictions should be structured to ensure that local compliance concerns are satisfactorily addressed within the framework of the compliance policy for the organization as a whole. As there are significant differences in legislative and regulatory frameworks across countries or from jurisdiction to jurisdiction, compliance issues specific to each jurisdiction should be coordinated within the structure of the institution's group-wide compliance policy. The organization and structure of the compliance function and its responsibilities should be in accordance with local legal and regulatory requirements.

Section 7. Outsourcing

Banks/ non-banks should establish policies for managing the risks associated with outstanding activities. Outsourcing of services/ activities can reduce the institution's risk profile by transferring activities to others with the necessary expertise to manage the risks associated with specialized business activities. However, the use of third parties does not diminish the responsibility of the board of directors and senior management to ensure that the outsourced activity is conducted in a safe and sound manner in compliance with applicable laws and regulations.

ANNEX IV

OVERVIEW OF PRINCIPLES OF CORPORATE GOVERNANCE

(Suggested Powerpoint Presentation Notes)

Three Pillars of Good Corporate Governance

1. FAIRNESS

fair treatment of shareholders, management, and stakeholders.

2. ACCOUNTABILITY

of the Board to shareholders and other stakeholders regarding the direction of the company and its proper conduct.

3. TRANSPARENCY

through check and balances, disclosure and reporting that are consistent with generally-accepted standards.

Fairness and Good Corporate Governance

PUBLICLY LISTED, PUBLIC COMPANIES AND FINANCIAL INSTITUTIONS,

- have a *public character*.
- are shaped by the welfare, not only of their shareholders, but also of other stakeholders that are part of their business processes.

ALL SHAREHOLDERS

- Good CG is about respect and protection of the rights of ALL shareholders.
- CG's main role is to promote long-term value of the shares...
of all shareholders, whether majority or minority shareholders, and whether active or passive shareholders.

ALL STAKEHOLDERS

- Good CG is about respect and protection of all *stakeholder* rights...
- stakeholders are those with significant claims on their company's resources and are affected by its business process.

Examples:

- creditors
- depositors
- suppliers
- customers
- officers and employees
- regulators, and
- the public

The dominant shareholders of publicly-listed companies contribute capital that often finance only a small part of the total resources of the company. The larger part of a publicly-listed company's assets is financed mainly by:

- other significant shareholders
- small shareholders & general investing public
- creditors (banks)
- the government (for taxes)
- employees (for unpaid compensation & benefits)

The entire financial & economic system of the country has an important stake in publicly-listed companies which have a fiduciary responsibility under the law.

THE BOARD OF DIRECTORS

- The Board of Directors of a publicly-listed corporation
- directs and manages, respectively, the business of the company in a way that is FAIR to ALL shareholders and stakeholders.

DIRECTORS

The Directors make prudent and fair judgments for the company.

Accountability and Good Corporate Governance

The Board of Directors has serious responsibilities.

The Board functions as a body of colleagues, with each Director bound by a DUTY of LOYALTY to the corporation as a whole (and not to any particular shareholder, e.g., the ones who got the Director appointed).

When are decisions "collegial"?

- when each Director is treated as an equal in terms of potential contribution, and
- when each Director can actually contribute his/her...
 - *free*
 - *autonomous*
 - *independent*
 - *informed* judgment on items for decision by the Board.

FINAL AUTHORITY over the business of the corporation is vested by Law... upon the Board of Directors.

The Board is therefore legally ACCOUNTABLE for corporate actions and decisions.

The Board of Directors is accountable for proper performance of its roles:

- *approve* strategies and major policies
- *set and review* business plans, financial objectives and plans
- *monitor* overall corporate performance
- *oversee* management, and
- *report* to regulators, shareholders and the general public.

Transparency and Good Corporate Governance

Fairness and accountability are ensured ...
through *disclosure* and *transparency* that are achieved through a system of:

- checks and balances
- monitoring and reporting

that are in accordance with accepted standards of proper and adequate disclosure (e.g., International Accounting Standards)

Checks and balances require drawing clear dividing lines between:

- *Shareholders*
(who have the right to be informed)
- *Directors*
(who perform governance functions and oversee management)
- *Managers*
(who perform the duties of day-to-day conduct of business operations)

Setting up a monitoring and reporting system that is :

- *accurate*
- *timely*
- *comprehensive*
- *easily understood* for the proper guidance and information of managers, directors and shareholders.

The Board should promote a culture of ETHICAL practices and SOCIAL RESPONSIBILITY

and exercise ethical and socially-responsible practices so that this culture

- *is kept alive and*
- *takes very deep roots*

throughout the company, from the Board of Directors all the way down to the rank-and-file employees.

ANNEX V

COMPLIANCE SYSTEM UPDATES (With Extension to Compliance with Governance Regulations)

(Suggested Powerpoint Presentation Notes)

Section 1: Compliance System

Basic elements of compliance system

- written compliance program approved by the Bank's Board of Directors.
- constructive working relationship with regulatory agencies.
- clear and open communication process within the bank to educate and address compliance center.
- Continuous monitoring and assessment of the compliance program.

Section 2: The Compliance Officer

Role & Function

- The principal function of the compliance officer is to oversee and coordinate the implementation of the compliance system. His responsibility shall include the identification, monitoring and controlling of compliance risk.
- An independent full-time compliance officer shall be appointed by every bank. His designation shall require prior approval of the Central Bank's Monetary Board.
- He shall have a rank of at least a Vice President and should have the skills and expertise to provide appropriate guidance and direction to the bank on the development, implementation and maintenance of the compliance program.

Role & Function for Other Types of Bank

- For other types of bank, an incumbent senior officer may be designated concurrently as the bank's compliance officer, provided, such designation will not give rise to any conflict of interest situation.

- Also, the internal auditor of a bank may be designated as its compliance officer subject to the condition that his primary duty will be to act as a compliance officer.

Section 1. Compliance Risk

Compliance risk is the risk of legal or regulatory sanctions, financial loss, or loss to reputation a bank/non-bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice.

- Central Bank of the Philippines Circular No. 429 Series of 2004

Section 2: Responsibilities of the board of directors and senior management on compliance

- The board of directors should oversee the implementation of the compliance policy and ensure that compliance issues are resolved expeditiously.
- Senior management should be responsible for establishing a compliance policy, ensuring that it is observed, reporting to the board of directors on its ongoing implementation and assessing its effectiveness and appropriateness.
- They should, at least once a year, report to the board of directors or a committee of the board on matters relevant to the compliance policy and its implementation, recommending any required changes to the policy.
- The report should assist the board members in making an informed assessment as to whether the institution is managing its compliance risk effectively.
- However, any material breaches of laws rules and standards shall be reported promptly.

Section 3: Status

The compliance function should have a formal status within the organization established by a charter or other formal document approved by the board of directors that defines the compliance function's standing, authority and independence, and addresses the following issues:

- measures to ensure the independence of the compliance function from the business activities of the bank;
- its role and responsibilities;
- its relationship with other functions or units within the organization;
- its right to obtain access to information necessary to carry out its responsibilities;
- its right to conduct investigation of possible breaches of the compliance policy;
- its formal reporting relationships to senior management and the board of directors; and
- its right of direct access to the board of directors or an appropriate committee of the board.

Section 4: Independence

- The compliance function should be independent from the business activities of the institution.
- It should be able to carry out its responsibilities on its own initiative in all units or departments where compliance risk exists and must be provided with sufficient resources to carry out its responsibilities effectively.
- It must be free to report to senior management and the board or a committee of the board on any irregularities or breaches of laws, and standards discovered, without fear of retaliation or disfavor from management or other affected parties. The compliance function should have access to all operational areas as well as any records or files necessary to enable it to carry out its duties and responsibilities.

Section 5: Role and responsibilities of the compliance function

- The role and responsibilities of the compliance function should be clearly defined.
- If there is a division of duties and responsibilities between different functions such as legal, compliance, internal audit or risk management, the allocation of duties and responsibilities to each function should be properly delineated.
- There should likewise be formal arrangement for cooperation between each function and for the exchange of relevant information.

Section 6: Cross-border Issues

- The compliance function for institutions that conduct business in other jurisdictions should be structured to ensure that local compliance concerns are satisfactorily addressed within the framework of the compliance policy for the organization as a whole.
- As there are significant differences in legislative and regulatory frameworks across countries or from jurisdiction to jurisdiction, compliance issues specific to each jurisdiction should be coordinated within the structure of the institution's group-wide compliance policy.
- The organization and structure of the compliance function and its responsibilities should be in accordance with local legal and regulatory requirements.

Section 7: Outsourcing

- Banks/ non-banks should establish policies for managing the risks associated with outstanding activities.
- Outsourcing of services/ activities can reduce the institution's risk profile by transferring activities to others with the necessary expertise to manage the risks associated with specialized business activities.
- However, the use of third parties does not diminish the responsibility of the board of directors and senior management to ensure that the outsourced activity is conducted in a safe and sound manner in compliance with applicable laws and regulations.
- This circular shall take effect after fifteen (15) days following its publication either in the Official Gazette or in a newspaper of general circulation.

ANNEX VI

SHORT ORIENTATION AND TRAINING COURSE FOR COMPLIANCE OFFICERS IN CORPORATE GOVERNANCE

CASES ON COMPLIANCE WITH CORPORATE GOVERNANCE POLICIES AND GUIDELINES

Teaching Objective:

The following six cases on compliance with corporate governance guidelines illustrate common practices in corporate governance of banks. It demonstrates the continuing need for improvement of governance practices and enforcing regulations. The role of the Compliance Officer in enforcing corporate governance regulations is highlighted in these case studies.

CASE 1: ON THE INDEPENDENCE OF THE AUDIT COMMITTEE OF THE BOARD OF DIRECTORS

Some Members of the Audit Committee hold executive positions of the Bank in violation of Section X163.9 of the Manual of Regulations for Banks (MORB), which provides as follows:

a. x x x.

b. The internal auditor shall report directly to the board of directors or to an audit committee composed of directors who do not hold executive positions in the bank.

Exception noted:

The following members of the audit committee hold executive positions:

Director	Executive Position	Functions
Mr. ABC	Executive Director for Corporate Banking and Branch Lending	Involved in the overall coordination of all corporate/institutional (wholesale), middle market (commercial), and consumer (retail) lending activities of the Bank; and ensure the maintenance of the quality credit process to ensure the steady growth of a profitable and stable portfolio.

Mr. DEF	Executive Director and Head-in-Charge of Credit Management & Asset Recovery	Responsible for the overall management and direction of all remedial, collection, legal and paralegal activities of the Bank; responsible for the maintenance of the existing credit policies and procedures ensure a continued quality credit process; and oversees the regular conduct of the credit review process to ensure lending procedures strictly adhere to existing credit policy guidelines.
Ms. GHI	Executive Director for Trust Group	Involved in Trust activities of the Bank, including the coordination of business of trust investment policies; and ensure the accomplishment of the business plans for the attainment of the overall growth and profitability of the trust portfolio.

The Bank's reply:

"It was resolved during the subsequent meeting of the Board of Directors that the members of the Audit Committee, who likewise serve the Bank as executive directors, will cease to serve the committee starting immediately. Henceforth, the members of the Audit Committee will only be Directors".

CASE 2: COMPLIANCE WITH THE CENTRAL BANK CIRCULAR ON THE CHARTERS OF THE COMMITTEES OF THE BOARD OF DIRECTORS

Amendment of the provision of the charters of Audit, Corporate Governance and Risk Management Committees to conform the provision of MORB Subsec. X141.3.c(9), as amended by BSP (Central Bank of the Philippines) Circular No. 456 dated 4 October 2004. Subsec. X141.3.c(9) of the MORB, as amended provides:

Specific duties and responsibilities of the board of directors

(9) *To constitute the following committees:*

Audit Committee. *The audit committee shall be composed of members of board of directors, at least two (2) of whom shall be independent directors, x x x*

Corporate Governance Committee. x x x The committee shall be composed of at least three (3) members of the board of directors. Two (2) of whom shall be independent directors. x x x

Risk Management Committee. x x x The committee shall be composed of at least three (3) members of the board of directors x x x

The various charters of the three committees of the Bank provide:

Audit Committee

The committee members shall be appointed by the board of directors and the Chairman of the committee will be designated by the board. The Committee will consist of four or more members, one of whom must be an independent director
x x x

Corporate Governance Committee

The Governance Committee shall be composed of four or more members of the Board of Directors. The Committee Chairman shall be an Independent Director.

Risk Management Committee

The Committee shall consist of a Chair and such directors/officers as the Board shall appoint. A minimum of three members of the board shall be selected to serve on the Risk Management Committee.

Exceptions noted:

The charter of the Audit Committee should be amended to conform with the provision of the MORB. The MORB provides that at least two of whom shall be independent directors, whereas the charter provides that one member of the committee shall be an independent director.

It was noted, however, that two members of the Audit Committee are independent directors. Still, the charter should be amended.

The charter of the Corporate Governance Committee should also be revised. Under the present set-up, the Committee has three independent directors as members whereas the charter provides that only the Committee Chairman shall be an independent director.

The charter of the risk management committee must also be amended. According to the MORB, it is the specific duty of the board of directors to constitute risk management committee which membership should be composed of at least three of themselves. The regulation does not say that such specific duty and function of the board of directors can be delegated to officers of the Bank, such that officers may be admitted to the committee to perform to specific duty of the board of directors.

The Bank's reply:

"We will comply. The amendment shall be included among the necessary updates when the related Board Committee Charters are reviewed and finally presented for approval to the Board of Directors which is being asked for under item 2 below. "

CASE 3: ON CHARTERS OF COMMITTEES OF THE BOARD OF DIRECTORS

Exceptions Noted:

Board Committee Charters have not been reviewed and updated.

The MORB provides that the board committee of charters should be reviewed and updated periodically or at least annually. The board of directors approved the charters since two years ago. Since then, it has not been reviewed and revised.

The Bank's reply:

"The Internal Audit Group has already raised the issue on the Audit Committee Charter to the Audit Committee in its last meeting. The result of review or any revision will be presented for approval in the meeting of the Board of Directors on its next meeting.

"The Risk Management Committee Charter was also reviewed during the meeting. The revised RMC Charter was approved by the Board of Directors in its next meeting. We have reviewed all other Board Committee Charters and updates will be introduced accordingly subject to Board approval in its next meeting."

CASE 4: ON THE AUTHORITY OF THE AUDIT COMMITTEE TO INVESTIGATE

Subsec. X141.3.c(9) of the MORB, as amended provides:

x x x

The audit committee shall have explicit authority to investigate any matter within its terms of reference x x x

Exception noted:

Review of the charter showed that the Audit Committee was not granted the such explicit authority to investigate. All that the committee was granted was the duty to review reports from management and other committees.

The Bank's reply:

"We believe that this requirement has been provided in the Bank's Audit Committee Charter. Under the Audit Committee's Purpose and Objective particularly in the first paragraph of page 2 states:

The Committee will have full access to the Bank's books, records, facilities and personnel. The Committee has the authority and available funding to perform or supervise special investigations, to engage outside experts, including legal and accounting experts,
x x x

Nonetheless, we will look into it whether to move the provision under the Audit Committee's Duties and Responsibilities."

CASE 5: ON THE PROPER LOCATION OR POSITION OF THE RISK MANAGEMENT COMMITTEE IN THE BANK'S ORGANIZATION CHART

Exception noted:

The Bank's organizational chart shows that the Risk Management Committee is under the Executive Committee, unlike other chartered committees. The review of the minutes of the Executive Committee also disclosed that indeed the Risk Management Committee reports to the Executive Committee.

The Risk Management Committee should be directly reporting to the Board of Directors since it was constituted to perform specific duty of the Board of Directors and not of the Executive Committee. Under BSP (Central Bank of the Philippines) Circular No. 456 dated 4 October 2004, it is mandated that the Risk Management Committee shall report regularly to the Board of Directors. The charter of the Risk Management Committee provides that it should report to the full board. The Bank violated its own internal regulation.

The Bank's Reply:

"The Risk Management Committee (RMC) does not report to the Executive Committee but reports directly to the Board of Directors."

CASE 6: ON THE BASIS FOR DISQUALIFICATION OF A DIRECTOR

Persons disqualified to become directors are (as amended by Circular 296 dated 17 September 2001 clarified by Circular 441 dated 16 July 2004):

"Directors who have been absent or who have not participated for whatever reasons in more than 50% of all meetings, both regular and special, of the board of directors during their incumbency, or any twelve (12) month period during said incumbency. This disqualification shall apply for purposes of the succeeding election; x x x"

Exception noted:

Review of the board meetings disclosed that Bank's Director Ms. "V" attended only six (6) of the seventeen (17) Board meetings, which was held from the board of directors' election on 15 July 2004 until their subsequent re-election in 21 June 2005.

Ms. "V's" attendance is merely thirty five percent of the total meeting (35%). Moreover, of the six (6) attended meeting, three (3) were through teleconferencing.

In accordance with the above provision, as amended by Circular No. 296, Director "V" is disqualified to become director of the Bank in the succeeding election of the Board of Directors scheduled sometime in June 2006.

The Bank's reply:

"The Board is confident Ms. "V" will have a good attendance record this year. Her accomplishments and track record speak highly of her qualification."



STATEMENT OF MISSION

*To advance sustainable development by strengthening
the development finance function and institutions, enhancing
capacity of members, and advocating development
finance innovations*



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