



FINANCIAL SUPERVISION COMMISSION

DEPOSIT TAKING (BANKS)

THEMED VISIT PROGRAMME 2011-12: CORPORATE GOVERNANCE – SUMMARY FINDINGS

DOCUMENT OVERVIEW

1. Introduction.....	1
2. Key findings.....	2
3. Action taken by the Commission.....	8
4. Our priorities for 2012-13.....	8

1. Introduction

- **Financial Services Rule Book (“Rule Book”)**
- **Guidance Note – The responsibilities and duties of directors under the laws of the Isle of Man (“Directors GN”)**
- **Guidance Note for Deposit Takers – Corporate Governance (“Corp Gov GN”)**
- **Proceeds of Crime (Money Laundering) Code 2010 as amended (“Code”)**

The Commission has a regulatory objective to secure an appropriate degree of protection for the customers of persons carrying on a regulated activity. The Rule Book, Directors GN and Corp Gov GN contain some important provisions in relation to corporate governance of both Isle of Man incorporated banks, and branches of banks based in other jurisdictions. It is important that banks have robust corporate governance arrangements in place to ensure appropriate control and oversight of their operation.

In order to fulfil our responsibilities the Commission carried out themed on-site reviews of certain banks’ corporate governance arrangements and processes with a particular focus on the composition, functioning and competence of the local Board, strategy and planning, independent non-executive directors, and Group inter-relations.

The purpose of this feedback is to highlight the Commission's key findings from the corporate governance on-site reviews that have taken place between February 2011 and March 2012.

2. Key findings

2.1 Non-Executive Directors (“NEDs”)

2.1.1 Common issues identified

Several common issues regarding the appointed NEDs were highlighted during the Commission's visits:-

- Upon appointment, NEDs were not, in all cases, receiving a formal letter of engagement (or similar) from the bank detailing the terms of their appointment and the bank's expectations of the NED role, including remuneration etc. The Commission feels that this is a best practice point for the industry, and guidance will be included within the Corp Gov GN (*see section “our priorities for 2012/2013” below*).
- Rule 8.33 (2) states that at least one director of a bank must be of independent non executive status. The Corp Gov GN provides guidance as to factors which would determine a NED's independence. In several instances the independence of the NEDs serving on the Board of banks could be challenged, particularly with regard to length of service, and conflicting duties. Generally, however, banks were taking steps to remediate such situations and the majority were in compliance with the requirements of the Rule Book.
- NEDs of some banks were not receiving ongoing training regarding relevant internal policies, or the regular AML/CFT training as required by the Code.
- Some banks were not ensuring that CPD was being undertaken by NEDs in accordance with Rule 8.5A (*also see section 2.5 below*).

For the avoidance of doubt, non executive directors include “group directors”, however group directors are not considered to be independent NEDs.

2.1.2 Remuneration

The Corp Gov GN, section 6.1.2, states that the remuneration of non executive directors, especially those who are members of board committees (for example audit or risk management committee) should take into account their responsibilities and

time commitments, but should not be unduly related to the short-term performance of the bank. Generally, the Commission found that remuneration took these responsibilities into account.

The below chart shows the total number of banks within a specific remuneration band for NED pay (this is based on the highest paid NED within that bank) based on a sample of 15 Isle of Man incorporated banks. Some NEDs within the same bank may earn differing amounts depending on any additional duties they conduct e.g. chairman of board, duties re other committees and other companies within the group etc.

<i>Under £10,000</i>	<i>£10,000-£19,999</i>	<i>£20,000 +</i>
<i>3</i>	<i>7</i>	<i>5</i>

2.2 'De Facto' Directors

In some banks there were external parties regularly attending and taking an active role in Board meetings. This could lead to the risk that they are regarded as a 'de facto' director (as outlined in the Directors GN), and assume personal liabilities as a result of this.

It was recommended by the Commission that these parties were either appointed formally as Board directors, or separated their duties so the 'de facto' director risk did not materialise.

2.3 Executive Director Service Contracts

In a number of banks executive Board members did not have any individual documentation/contract which set out the terms and conditions of them acting as a Board member (separate from their job role/specification). The Commission feels it is important that executive directors are aware of any additional director responsibilities which may be required of them in addition to their normal job role, particularly requirements of attendance at Board meetings. The Commission observed some cases where attendance by executive directors at meetings was considered to be insufficient and unacceptable.

The Commission informed banks where shortfalls were identified and that it would be updating its guidance for the industry as a whole upon the conclusion of the themed visit process (see section "our priorities for 2012 / 2013" below). Annex A contains an extract from the Institute of Directors Factsheet 'A Director's Service Agreement'.

2.4 Governance Structure/Codes

Section 7.2 of the Corp Gov GN details the basic information the Commission considers should be made publicly available as appropriate for the business (based on size, complexity, ownership structure, and risk profile). Not all banks made this information available to the public, for example through their websites and / or published financial statements.

2.5 Continuing Professional Development ‘CPD’

During the visits it became apparent that banks were not always ensuring that all directors and key staff were undertaking CPD in accordance with Rule 8.5A.

The majority of banks were maintaining a record of CPD for local executive directors, but this was not the case for all NED and Group directors. The Commission acknowledges that Group directors may be subject to equivalent requirements in their home jurisdiction, and further that directors or staff members may also be subject to the requirements of a professional body.

The Commission considers that where a bank is satisfied its Group directors are subject to Group CPD standards and monitoring which would cover the local requirements, there is no separate need for these directors to attest to the local bank. In relation to independent NEDs, the Commission considers that it would be acceptable for a bank to receive an attestation from these directors on an annual basis as to whether they have undertaken CPD as required by the Rule Book (see section “our priorities for 2012 / 2013” below).

2.6 Conflicts of Interest

2.6.1 Recording of conflicts

There were instances within banks where potential or actual conflicts of interest of staff members/directors/NEDs had not been detailed in the conflicts of interest register. In some situations, the conflict had been advised to, and considered by, the bank, but not formally recorded. All conflicts should be recorded so as to help demonstrate they are being managed appropriately and rule 8.8 (2) sets out the information which should be recorded in a conflicts of interest register.

The Commission feels it is appropriate for banks to review this register on at least an annual basis to ensure the recorded conflicts are still current, and being managed appropriately. In accordance with Rule 8.19 (d) the Compliance Officer of a bank is responsible for ensuring the conflicts of interest register is maintained. This review was not always being conducted.

The Commission would also expect there to be a reminder issued to staff of their responsibilities under this policy on a regular basis.

2.6.2 Types of conflicts and obtaining information

In addition to Rule 8.7, section 3.3.7 of Corp Gov GN provides guidance around areas that the Commission believes should be covered within a bank's conflicts of interest policy. The Commission also expects banks to obtain details of any external directorships and other interests held by their directors (including NEDs) and employees. Any returns provided in this regard should be reviewed to ensure that any matter which may give rise to a conflict of interest is identified, disclosed and managed appropriately. Further, any relevant potential conflicts of interest for directors should be disclosed at the commencement of Board meetings, based upon the agenda and matters to be discussed, in order to determine whether the conflict means certain directors should exclude themselves from parts of the meeting and/or abstain from voting on specified matters.

The Commission notes that its guidance is not explicit in this area and this will be strengthened during 2012 (*see section "our priorities for 2012 / 2013" below*).

2.7 Internal Audit and External Audit

2.7.1 The role of the Board

Rule 8.6(4)(a)(iv) requires Isle of Man incorporated banks to ensure appropriate independent internal audit and compliance procedures are in place to test adherence to the regulatory requirements. It was observed in some banks that the Board could not demonstrate that it had considered whether the adequacy of the internal audit function was appropriate to the bank.

The process for the tracking of issues raised by internal audit was not always clear, particularly in terms of local responsibility and Board reporting. This is considered an important matter as good quality reporting helps to provide assurance to the Board that all issues raised are being dealt with appropriately.

2.7.2 The role of independent NEDs

In some smaller banks, where there is no requirement for an audit committee (or similar), it was recommended by the Commission that there should be an arrangement in place for the independent NEDs to meet independently with the internal and external auditors on at least an annual basis to enable both parties to discuss any relevant issues. This is covered in section 5.3.1 in the Corp Gov GN.

2.8 In-sourcing/Outsourcing

2.8.1 General governance

Most banks held a schedule of in-sourced/outsourced functions, however, some schedules were outdated, and did not cover all functions undertaken. The Commission also found that in some banks the service agreement(s) covering outsourced functions were also outdated in terms of the services being provided to/by the bank. The Commission feels it is important that the overarching schedule and individual agreements are regularly reviewed to ensure all services provided are covered and the correct regulatory requirements are also referred to within the agreements where appropriate.

Further, in some banks it was not evident that in-sourced/outsourced activities were subject to an independent review to ensure the adequacy of the arrangements and governance processes around these activities. It was also unclear in some cases what contingency plans were in place in the event of an outsourcing agreement being terminated, or in the failure of the service organisation to perform the outsourced function.

2.8.2 Materiality

For some outsourced functions, it was not evident that banks had considered the materiality of the function, and whether it was necessary to obtain the consent of the Commission for this prior to the outsourcing being undertaken, in accordance with Rule 8.13.

2.9 Risk Management and Internal Controls

2.9.1 Risk Management Framework

The Commission believes it is appropriate for banks to have a risk management function (appropriate to the size of the business) to ensure there is appropriate control of the risks to which the business is exposed. Although there were forms of risk management frameworks in place across all banks, some were not as robust as they could have been. For example, although various risk processes and risk reviews were undertaken within a bank, there was not a specific or sufficient risk management function (in the IOM) to identify, measure, monitor and control risks to which the business is exposed.

It is important that banks consider all risks to their business and how best these can be mitigated. Further, information regarding key risks and vulnerabilities that the bank face should be provided to the board, including how such risks are controlled and managed.

2.9.2 Services and Products

It was noted that there was not always a policy in place within banks regarding the design and sign off of new products and services, taking into account the risks associated with that product/service, and the notification requirements of Rule 8.10. The Corp Gov GN states that the risk management function should provide input on risks as part of the new products and services process, however, it was further evident in some banks that where there was a policy in place relating to this, the policy did not make reference to the role of the local (and Group as applicable) risk management and compliance function in this process.

2.9.3 Staff Competence and Roles

Banks should ensure that, where appropriate, risk management objectives are reflected within staff role profiles and performance management assessments (*also see section 2.10 below*). It was not always apparent that risk matters had been considered in the setting of objectives and assessment of performance.

2.10 Staff Competence, Training and Remuneration

2.10.1 Role Profile and Performance Management

The Commission believes it is important that the role profile and performance objectives set for staff members contain sufficient risk and control objectives, alongside other role requirements or target business unit deliverables. Banks should ensure that there is a balance to ensure risk and compliance issues are targeted and measured where applicable, which was not always the case. The Commission will be strengthening its guidance in this regard (*see section “our priorities for 2012/2013” below*).

2.10.2 Disciplinary Action

Formal procedures were not in place in all banks which ensured staff disciplinary action was notified to the Commission appropriately in accordance with Rule 7.10. In some banks there were no documented HR procedures for dealing with capability and the link from this to disciplinary action. It is important that staff understand the disciplinary process of their employer, and their rights under this process.

2.10.3 Training

Not all banks provided standard formal induction training for new entrants as appropriate. The Commission believes it is important that new staff receive

specialised training regarding the policies and procedures within the bank that are applicable to them, alongside compulsory regulatory training e.g. AML/CFT.

Where existing staff are required to undertake mandatory training throughout the year, banks should ensure they monitor that the training is completed within the relevant timeframe, especially for AML/CFT training as required by paragraph 22 of the Code. In some banks the Commission observed that such training was not always completed in a timely manner.

2.10.4 Key Persons

Based on structure charts, grades of staff and their duties, there were cases identified where senior management personnel had not been notified to the Commission for vetting as “Key Persons” (as defined in section 48 (1) of the Financial Services Act) in accordance with Rule 7.9. The Commission’s general guidance and training and competence framework states that members of the senior management of a banking function are considered to be examples of Key Persons.

3. Action taken by the Commission

The Commission does not consider that there have been any major issues identified that would cause a significant threat to its Regulatory Objectives (as set out in the Commission’s published Supervisory Approach), and that the Rule Book and Corp Gov GN remain appropriate. Individual banks have been required to take action where applicable. The Commission has already provided feedback to banks and expects banks to take note of the findings and good practice points explained above.

The Commission found it useful to observe how banks’ governance structures are operating and how they had considered the key areas covered in the Corp Gov GN. In respect of this the Commission is proposing to review its Corp Gov GN to provide more clarity in areas of best practice as explained in “our priorities for 2012 / 2013” below.

4. Our priorities for 2012 / 2013

The Commission is seeking to update its Corp Gov GN to expand further in relation to the following areas:-

- Letter of engagement for NEDs (including independent, group and other directors)
- Conflicts of interest
- Executive director service agreements
- CPD and the application to independent NEDs and Group directors

- Risk and control matters in performance management processes

Recently, the Commission issued a guidance note on operational risk management (March 2012) as part of strengthening risk management and governance arrangements as a whole. The Commission is also currently working on revisions to guidance on the Internal Capital Adequacy Assessment Process (ICAAP), following feedback recently issued to banks, which links to corporate governance and risk management.

Annex A

A Director's Service Agreement¹

An executive director has certain rights and obligations arising as an employee as well as a director of a company. A Director's Services Agreement should include the following information:-

- Appointment commencement date, employment commencement date (which may be different), notice required by either party to terminate the agreement and the normal retirement age which cannot be under 65 unless objectively justified for the role in question (which in practice is difficult);
- Duties of the director including any provisions under which a director may be required to serve on the boards of companies within a group of companies;
- Limitations on the director in engaging in business or professional activities outside the employment, and method of obtaining prior approval if such activity might be acceptable to the company;
- Remuneration details: salary, bonus schemes, share options, medical insurance, life and disability insurance, pensions, company car and/or other benefits including sufficient flexibility for the company to review, amend or withdraw the benefit in appropriate circumstances;
- Details of reimbursement and authorisation for expenses;
- Location of the director's main place of work, arrangements relating to any future change of location on a permanent or temporary basis and details relating to the requirement to travel for business;
- Holiday entitlements;
- Entitlements relating to pay during periods of absence due to sickness or accidents;
- The right for the company to require the director to undergo a reasonable medical examination and for the reports from such examinations to be disclosed to and discussed with the company;

¹ Any director's service agreement implemented by a bank incorporated in the Isle of Man would of course need to be compatible with the relevant company law.

- Provisions concerning disclosure of company information which is considered confidential;
- Provisions relating to intellectual property issues;
- Circumstances under which the service agreement may be terminated by the company without notice;
- Where the grievance, disciplinary and appeals procedures may be found (the procedures themselves normally being non-contractual);
- Details of any constraints that may apply to the director on leaving the company including working for a competing organisation, setting up in competition to the company, soliciting or dealing with company clients and poaching senior members of staff;
- Other provisions relating to the termination of the employment including the right for the company to give pay in lieu of notice and/or place the director on gardening leave and the return of company property;
- Specification of which law governs the agreement (e.g. the law of the Isle of Man);
- Evidence that the agreement has been approved by the board.

The IoD Directors' Advisory Service's Factsheet 'Director's Service Agreement – items to include' gives a more in-depth guide of matters to be included in a Director's Service Agreement.

Further, the Commission would also expect details of the company's expectations of the director in relation to attendance at board meetings to be included in any agreement.