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Dear Mrs Bury

**CEBS response to green paper on corporate governance in financial institutions and remuneration policies**

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union welcomes the opportunity to comment on the European Commission's Green Paper (COM 2010\_284/3) on corporate governance in financial institutions and remuneration policies.

In the appendix CEBS provides a number of general comments on the Green paper and how it interacts with work we have been and are in the process of carrying out in that area. We do not address all the questions put forward in the consultation, but rather focus on a limited number. In particular we take this opportunity to comment on external audit issues raised in the Green paper, which are not directly in the scope of our work on internal governance.

If you have any questions regarding our comments, please feel free to contact the Secretaries in charge of the subgroups Bernd Rummel (T. +44 20 7382 1767) or Guy Haas (T. +44 20 7382 1784).

Yours sincerely



Giovanni Carosio

## Appendix

### General comments

CEBS very much appreciates the work of the European Commission to enhance the corporate governance framework applicable for financial institutions. This also includes strengthening banking supervision. An enhanced corporate governance framework, if implemented in a sound way, should enhance the stability of institutions and the financial system. CEBS supports the European Commission's view that the regulation should be applied in a proportionate way. However, in some cases the suggestions contained in the Green Paper seem to be quite definite.

CEBS is currently reviewing its internal governance guidelines based on the weaknesses and the room for improvement identified in its survey on internal governance. CEBS will also take into account the update to the Basel Committee guidance - *Enhancing corporate governance for banking organisations*. Besides a review of the guidelines on internal governance, CEBS aims to develop a comprehensive guidebook of internal governance principles by taking into account the *High level principles on risk management* and the *High level principles on remuneration policies*, also including references to internal governance guidelines contained in other CEBS guidelines.

In January 2010 CEBS has already sent a report to the European Commission based on the results of the aforementioned survey. Specific attention will be given to the implementation of the new guidelines and therefore CEBS will develop implementation plans (e.g. including workshops or seminars) and conduct implementation studies for the new guidelines. The implementation and ongoing use of sound governance principles and risk management and control procedures by institutions is a key issue. A consultation paper on the updated guidelines will be published in the fourth quarter 2010.

The guidelines will reflect CEBS's current thinking on internal governance related issues and for that reason CEBS will not provide you with detailed responses to all questions. The services of the European Commission (DG Internal Market) are invited to the meetings and associated with the work of CEBS Internal Governance Task Force and Remuneration Task Force preparing an update of internal governance and remuneration guidelines. The European Commission should consider the upcoming CEBS guidelines, when evaluating the need for additional regulation in the field of governance and remuneration.

CEBS shares the European Commission's view and will consider in the guidelines mentioned above that there is the need to improve the requirements on the composition of the management body, in particular with regard to its supervisory function, so that it can provide sufficient challenge to management's decisions. The management body needs to have in the first place integer, sufficiently qualified and experienced members, both individually and collectively. Those members should know and understand the institution's structure and the risks of its business on an ongoing basis. Changes due to mergers and acquisitions, new products, processes or systems have to be accommodated swiftly in governance arrangements, including the knowledge needed to keep the changed risk profile under control. This applies also to staff in the business lines and the risk control function. The assignment of appropriate board members is in the first place the responsibility of the institution, however CEBS supports also the idea of intensifying the assessment of the fitness and property of the management body in its supervisory function by supervisors.

To strengthen banking supervision CEBS also aims to improve the cooperation of supervisors within colleges. Guidelines on Supervisory Coordination have already been published and a framework for Joint Risk Assessments has been developed. Supervisors should already be in the position to assess the functioning of institutions' governance arrangements. However, to exercise sound supervision and to intensify it even more, member states need to ensure that supervisory authorities have sufficient resources, budget and powers. This also applies to the future European Banking Authority.

CEBS has also some concerns on the limitation of the number of boards on which a director may sit, as this may not ensure sufficient time devotion and might contradict the principle of proportionality.

As mentioned before CEBS also takes this opportunity to comment on external audit issues which are not in the scope of CEBS's work on internal governance.

### **Detailed comments on select questions raised in the Green Paper**

#### **Question 1.1: Should the number of boards on which a director may sit be limited (for example, no more than three at once)?**

Sufficient time devotion is crucial for the well functioning of the board (management body in its supervisory function). The needed amount of time differs depending on the size and complexity of the institution and also on the size of the board, the function of the person within the board and the system used in national company law (1 tier versus 2 tier system). Even a strict limit of the number of mandates cannot guarantee sufficient time devotion of members, as such a limit would not impede them to have other occupations or develop other professional high-time consuming activities, which is not limited to board functions. A definite limit of possible board mandates might also contradict the principle of proportionality, if the institutions size and complexity is not taken into account.

For these reasons, CEBS does not see the number of boards on which a financial institution's director may sit as a sufficient measure to ensure adequate time devotion (although it might be desirable as a benchmark). Members of the management body should challenge how individual members will be able to spend sufficient time fulfilling their responsibilities. If a measurable limitation is desired, the number of days available for actual work in the supervisory function might be used. However this should be implemented in a proportionate way as a benchmark figure.

Irrespective of how a potential limit would be defined, in any case the limit should consider that the needed time devotion would be depending not only on the size and complexity of an institution, but also on how similar the tasks in the different institutions are. More flexibility should be applied at least in cases of multiple supervisory mandates in institutions belonging to the same financial group or institutional protection scheme (as used in Art. 80 para. 8 of Directive 2006/48/EC), if the board members can document that they are able to devote sufficient time and effort to fulfil their responsibilities.

#### **Question 3.1: Should cooperation between external auditors and supervisory authorities be deepened? If so, how?**

Currently there is no requirement in the European Directives 2006/43/EC (Audit Directive) and 2006/48/EC (taking up and pursuit of the business of credit institutions) that imposes cooperation between external auditors and supervisory authorities.

In principle, CEBS is of the view that cooperation between external auditors and supervisory authorities could be beneficial for the reasons explained in the Green Paper. As learned from an internal stock take CEBS carried out on the role of external auditors in banking supervision some years ago, it appeared that a large majority of banking supervisors already meet with external auditors to discuss relevant aspects of the audit for banking supervision purposes. However, it is also important that those meetings are as effective as possible.

In that context, the European Commission could analyse how best to articulate the existing cooperation between external auditors and supervisory authorities and to examine the need for an adequate legal framework

The European Commission could notably explore whether there are currently any legal barriers in place – either at European or at national level - that would prevent deepening cooperation, such as – at least possibly - existing confidentiality requirements within the auditing profession. Any barriers to information sharing would reduce the effectiveness of the meetings.

As part of this analysis, the European Commission could also consider whether there is a need to amend Article 53 of the Directive 2006/48/EC and introduce – in addition to the existing duty to report in paragraph (1) – a right to report to the supervisory authority.

In terms of forms of cooperation, the European Commission could take inspiration in models that are already being applied in European countries – either as a result of national legal requirements or in accordance with voluntary arrangements - , including:

- regular communication between the external auditor and the supervisor e.g. in routine meetings (including trilateral meetings involving the client); and
- reporting requirements to the supervisory authorities (such as copying the authorities in on management letters, preparing long form reports or other reports which currently vary from country to country).

In addition to the cooperation at entity level, there are arguments for an enhanced cooperation between external audit firms and supervisors at national level (for sectors and across sectors) and at European level between supervisory and auditing bodies. This cooperation could be used to discuss sector wide developments, including highlighting developing problems in the banking sector.

### **Question 3.2: Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?**

Overall, CEBS is of the view that, while there may not be a direct need to increase external auditors' duty of information towards board of directors and/or supervisory authorities, further guidance would be welcome.

As regards the duty of information towards the boards of directors, auditors are already required under clarified international auditing standards (ISAs) to report to 'those charged with governance' significant findings from their audit work (ISA 260,

*'Communication with those charged with governance'*). Pending the endorsement of ISAs in the EU, the EC could examine the need for similar requirements in national legislation,

Moreover article 53 of Directive 2006/48/EC already covers the auditors' duty to report to the competent authorities items which:

constitute a material breach of the laws, regulations or administrative provisions which lay down the conditions governing authorization or which specifically govern pursuit of the activities of financial undertakings, or

affect the continuous functioning of the financial undertaking, or

lead to refusal to certify the accounts or to the expression of reservations.

These requirements are nonetheless rather broad in nature and thus could be interpreted in different ways. Clarified ISA 260:Section B *'Auditor's right and duty to report to regulators in the financial sector'* also contains requirements regarding the auditor's reporting duty to supervisory authorities but further guidance regarding the specified circumstances on which to report and the specific duties of the auditor would be useful.

Any guidance developed in this area could take inspiration from a document the Basel Committee on Banking Supervision published in association with the International Auditing Practices Committee (the predecessor of the IAASB) in January 2002 on *'The relationship between banking supervisors and banks' external auditors'*, in particular paragraphs 46-55, which emphasise that in many respects banking supervisory authorities and external auditors have complementary concerns regarding the same matters but the focus of their concerns may differ.<sup>1</sup> Also of interest in that context could be another document the Basel Committee published in August 2001 on *'Internal audit in banks and the supervisor's relationship with auditors'*.

Moreover, the European Commission could consider – in addition to the auditor's duty to report promptly to supervisory authorities in those circumstances set out in Article 53 of Directive 2006/48/EC – to also include a mandatory annual reporting requirement, within a specified timescale, for the external auditor to report to supervisory authorities whether or not circumstances have arisen that require him/her to report a matter to them, and if such circumstances have arisen, to specify those circumstances.

In CEBS' members experience, external auditors seem to be reluctant to breach their duty of confidentiality towards their clients, despite the fact that a disclosure in good faith to a competent authority shall not constitute a breach of their duty of confidentiality according to article 53.2 of Directive 2006/48/EC. CEBS members feel that this observation merits further consideration and possibly, further discussion with the profession.

### **Question 3.3: Should external auditors' control be extended to risk-related financial information?**

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<sup>1</sup> Known in the IAASB Framework as International Auditing Practice Statement (IAPS) 1004. The Board is in the process of revising the authority and status of the IAPSS and may decide to withdraw this document while at the same time exploring how the relevant material may be maintained, not as an IAPS but in another form.

Before answering the question of whether external auditors' control should be extended to risk-related financial information, CEBS is of the view that it needs to be clarified what this 'risk-related information' encompasses.

Indeed, this could cover risk-related financial information but also information on risk appetite and parameters of risk management systems (such as a 'risk statement'). The answer on whether this information should be covered by the external auditors' control very much depends on the scope of the information and the existence of appropriate benchmarks.

In this context, it would be helpful to clarify the scope of an external auditor's control. For example in some annual reports of banks the external auditor's report already covers the risk management section of the annual report without going into detail on what this control of the risk management section encompasses. It could also be worthwhile exploring the options to focus more on risk-related financial information in the current audit work on annual reports.

CEBS would welcome a debate on the merits of an extension of the auditor's control to risk-related financial information. Any extension needs be carefully considered in order to avoid unwanted consequences in terms of liability and or conflicts with supervisory or other regulatory interests. Moreover, it should be acknowledged that the extension of the statutory audit work could imply important additional costs to audited companies which would have to be assessed against the potential gains.