New Elements in Corporate Governance of the Credit Institutions from the Perspective of National Bank of Romania Regulation no. 5/2013

Gabriela-Ioana MOISE, PhD candidate

Andrei-Emil MOISE, PhD

Abstract: The global economic crisis has stretched its harmful effects including banking activity, this being one of the severely affected economic domains where the greatest efforts of resuscitation were done, sometimes with serious consequences over public money. In this context, restoring the credit institutions' activity on actual basis, through a more efficient organizational system and re-editing the attributions of the management organs, so that to be able to guarantee for an effective and fast risk management framework, represented a globally assumed goal. Romanian law cannot remain outside this framework especially considering the obligation to join the model imposed by the European legislator by taking over the domestic law of the European directive CRD IV. This paper proposes a comparative study between the current and the previous legislation in order to highlight the main elements of novelty brought by Basel III, CRD IV and GL Guide 44/2011 on the internal governance of credit institutions elaborated by the European Banking Authority.

Keywords: economic crisis, credit institutions, CRD IV, Basel III, European Banking Authority, internal governance

1. Introduction

Corporate governance in the case of credit institutions, representing the of sum rules, principles and norms that regulate the organizational and management framework of the credit institutions' activity, traditionally found its regulatory premises into the Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy[18], its provisions being complemented by National Bank of Romania Regulation No. 18/2009 concerning the administration of the activity of credit institutions, the internal assessment of capital adequacy to risks and conditions of outsourcing their activities.

The amendment of GEO 99/2006 operated by GEO 113/2014 on some budget measures and for amending and supplementing the Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy[19], as well as the partial repeal of Regulation No. 18/2009 by NBR regulation No. 5/2013[20], represents the alignment of national legislation in the field of credit institutions to the new regulations adopted by the Council of Europe and the European Parliament, respectively the Regulation[21] and the Directive[22]

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[18] GEO 99/2006 on credit institutions and capital adequacy, published in the Official Journal of Romania No.1027 from 27.12.2006, approved by Law No. 227/2007 for the approval of the Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy (OJ No. 480 from 18.07.2007), subsequently amended and supplemented

[19] Published in the Official Journal of Romania No. 830 from December 23, 2013

[20] published in the Official Journal of Romania No. 841 from December 30, 2013

[21] EU Regulation Nr. 575/2013 of the European Parliament and of the Council of Europe from June 26, 2013 concerning the prudential requirements for credit institutions and investment companies, amending (EU) Regulation No. 648/2012, published in the Official Journal of the European Union L 176, volume 56, from June 27, 2013.

concerning the prudential requirements in credit institutions' activity, generically called CRD/CRR IV[23] Package.

1.1 The European context for the regulation on the framework of the credit institutions' management

The CRD/CRR IV Package adopted by the European Parliament and the Council of Europe represents the European legislator's solution for strengthening of the banking system, by increasing the potential of anticipation, surveillance and counter the specific risks occurring in the banking activity, the adoption of the legislative package being mainly a response to the effects of prolonged economic crisis on the financial sector.

Global financial crisis has revealed the existence of gaps in the previous regulation at European level, generically called *Capital Requirements Directive* - CRD (European Directive on the capital adequacy), the legislative package comprising Directives 2006/48/EC and 2006/49/EC, that reflected the proposals of the Basel Committee for Banking Surveillance[24] included in Basel II agreement.

Although Basel II proposed an efficient strategy of risk management in banking activity, founded on three pillars: minimum capital requirements, capital adequacy surveillance and internal surveillance of the Bank as well as market discipline – its regulations were not sufficient to ensure the absorption of the economic shock represented by the financial crisis.

This conclusion became obvious especially at the moment of awareness of the effects of cross-border financial groups collapse, insurmountable harmful effects for national Governments that were forced, in the absence of effective and appropriate tools, to appeal to the public money to give to the banks already disagreeable "*bail-out option*". So, the insufficient or weak development of risk management instruments has led to the undesirable effect of profit's privatization, but also conferring a social character to the losses (*privatizes profit, socialize losses*).

Specifically, the gaps in the regulatory framework based on Basel II consisted mainly in:*(i)* the basic capital of credit institutions did not have the quality and rank required to properly absorb losses; *(ii)* the deficient liquidity management; *(i)* the lack of an efficient and effective corporate and internal governing.

Starting from these issues, by the Declaration on the occasion of the G20 Summit of 2 April 2009, world leaders have assumed the obligation of international cooperation and concentration of efforts in order to recover the effects of the economic crisis by improving the quantity and quality of capital in the banking system, through the introduction of additional instruments to stabilize and measure the risk in banking activity, as well as through the development of a new regulatory framework.

The objectives undertaken by the leaders of the G-20 had been achieved through the development by the Basel Committee, on the basis of rules approved by the leaders of the G-20 and the Financial Stability Board at the Pittsburgh Summit from September 24-25 2009, of

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[22] Directive 2013/36/EU of the European Parliament and of the Council of Europe from June 26, 2013, on access to the credit institutions' activity and prudential supervision of credit institutions and investment companies, amending Directive 2002/87/EC and repealing directives 2006/48/EC and 2006/49/EC, published in JOUE, L 176, volume 56, from June 27, 2013.

[23] Acronyms CRD/CRR come from "Capital requirements directive/regulation"

[24] The Basel Committee is composed of representatives of the supervisory authorities of Belgium, Canada, Switzerland, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, United Kingdom and United States. Typically, they meet at the BIS headquarters (Bank of International Settlements) from Basel, where the permanent secretariat is located.

the new global standards for regulating banking activity, known as Basel III, taken in the European space through the legislative package CRD IV.

We may note that, in terms of European settlement CRD IV, progress towards the previous legislative package refers not only to the content of specific measures of risk management but also to a legislative technique feature – the current legislative package is composed of a regulation and a directive (unlike the previous package consisting of two directives), which ensures speeding up the implementation of the adopted measures, considering that regulation is to going to apply directly to national jurisdictions, without having to be taken over by domestic law.

1.2 The internal regulation

Regarding the national regulatory framework, European Regulation No. 575/2013 concerning the prudential requirements for credit institutions and investment companies apply directly in domestic law, and European Directive 2013/36/EU on access to the credit institutions' activity and prudential surveillance of credit institutions and investment companies was transposed to a double level in domestic law:

- At the level of primary legislation – modifying the GEO 99/2006 by the GEO 113/2013, normative act specifically aimed at strengthening the regulatory framework for credit institutions in the areas of corporate governance, prudential surveillance and sanctions regime;
- At the level of secondary legislation – by issuing the NBR Regulation No. 5/2013 on prudential requests for the credit institutions, including provisions of Directive CRD IV missed by the primary legislation, provisions about Romanian legislator's option in areas where the European Directive gives only a principled regulation, provisions of the guidelines issued by the European Banking Authority (EBA) in 2011 in the fields covered by regulation as well as principles in the Basel Committee documents.

So, we may note that the domestic regulation on corporative governance of the Romanian credit institutions is the result of combining Basel III agreement, the European Directive CRD IV, with those issued by the European Banking Authority (EBA), respectively EBA Guidelines on Internal Governance GL 44/2011.

The reason for this legislative synthesis process is the purpose unity of the Directive CRD IV and of EBA Guidelines 2011 regarding the improvement of corporative governance.

Thus, the reasons for the appearance of EBA Guidelines 2011 on internal governance are represented, on the one hand, by the results of the evaluation carried out by CEBS (Committee of European Banking Supervisors) at the end of 2009, which has led to a number of difficulties in implementing the corporate governance Guidelines 2006 Edition, related to the organizational structure and organization, the surveillance exercised by the supervisory bodies, risk management and internal control, and on the other hand, the motivation lies in the work of other bodies (European and international) on the corporate governance (especially Principles for enhancing corporate governance, issued by Basel Committee in October 2010).

In order to give the possibility of credit institutions for effective implementation of the new legal provisions, Romanian legislator has made a difference in terms of the entry into force of the NBR Regulation No. 5/2013, following that its provisions which ensure implementation of Directive CRD IV to enter into force on January 1, 2014, and those provisions that take over into the Romanian legislation of the EBA Guidelines to enter into force on July 1, 2014.

2. Corporative governance as risk management tool

The Basel III agreement, as well as the adopted European legislation, follows essentially the idea to cover, anticipate and counter the various risk types that may appear in banking activity by proposing risk management tools.

In corporative governance domain, deficiencies in the functioning of the administrative framework of the credit institution, determined by the regulatory failure under previous legislation, have led to excessive and unwise risk-taking and through it to the bankruptcy of some credit institutions and systemic problems. The direct consequence of these issues was a need for strengthening corporate governance regulation for the purpose of preventing excessive and unwise risks [25].

So, the CRD IV Directive transforms the effective and efficient corporate governance into a real risk management instrument, considering that the main elements of novelty introduced by the European legislator refers to the clarification and standardization of structures and mechanisms for corporate governance in credit institutions, imposing a set of defining and detailed rules on the composition of the governing bodies, the functioning of the various governing structures and their role in terms of risk surveillance activity and development of risk management strategies. It is also a strengthening of the status and independence of the risk management function and is defined the role of supervisory bodies regarding monitoring of the specific risks of credit institution.

The main elements of novelty brought about by Regulation 5/2013, and the transposing of EU legislation ensured by it and by EBA Guidelines 2011 on internal/domestic governance (GL 44/2011), compared to the previous regulation (Regulation No. 18/2009), are presented as follows:

The new regulations imposed by GL 44/2011:

- GL 44/2011 defines the management structure in the sense of Regulation 18/2009 and contains in addition the stating that the persons who effectively direct the activity of credit institutions are also included.
- The management framework (internal governance) is a crucial component of corporate governance and includes at least the following aspects:

  a) organizational structure and organization of the credit institution;

  b) the responsibilities of credit institution's governing structure, its function and composition, the general framework for this purpose;

  c) risks management;

  d) internal control;

  e) information systems and the continuation of the activity;

  f) transparency requirements.

  Compared to the previous activity management framework component (Article 3 paragraph 1 of Regulation 18/2009), GL 44/2011 introduces two new components: risks management and information systems and the continuation of the activity.
- The provisions on organizational structure and organization of the credit institution are not much different of those of the Regulation No. 18/2009, being structured/delimited differently:

  - organizational framework;
  - examining and balancing the group structure;

- [25] Robu R. (2014), " International governance in the context of applying the CRD IV", the Colloquium " Challenges for legal work in the context of the new prudential regime for credit institutions", National Bank of Romania, March 19, 2014, published by http://www.bnr.ro/Colocviile-juridice-ale-BNR-10754.aspx

- structure knowledge (operational) – is a task for the management structure – non-standard activities / routinely performed or not transparent.

- Compared to existing provisions on the management structure's responsibilities from Regulation No. 18/2009, GL 44 structures the management as following:

- duties and responsibilities of the management structure of credit institutions – as a novelty, regroups under one paragraph the main responsibilities of the governing structure, making the distinction between the general business strategy and general risk policies and strategies of credit institutions;

- composition and functioning of the management structure – on one hand, introduces a number of novelty items regarding the management structure, its hiring, management of conflicts of interest within the leadership structure and qualification of members of the management structure, and on the other hand establish a series of remarks on the functioning of the governing structure, including from the perspective of its specialized committees (committees that might include an audit committee, a risk Committee, a remuneration Committee, a Nominating or human resources Committee and/or a governance Committee or ethics or compliance);

- the general framework for the purpose (*business conduct*) involve the following aspects: corporate values and code of conduct, conflicts of interest at the level of the credit institution and internal alert procedures.

- From the perspective of GL 44/2011 risk management involves:
  - the existence of a culture regarding risk;
  - remuneration alignment to the risk profile;
  - risk management framework;
  - the existence of a policy on new products.

Unlike risk management in the framework of regulation No. 18/2009 (chapter 3), GL 44 regulates the risk management framework that involves policies, procedures, boundaries and controls, in order to ensure the identification, measurement or evaluation, monitoring, mitigation and reporting risks related to activities both at the level of the lines of activity, as well as the overall level of credit institution.

- In the perspective of GL 44/2011, internal control means, as in the case of Regulation 18/2009, the existence of a framework for internal control. This is the equivalent of the internal control system governed by Regulation No. 18/2009, because as for the internal control system ensures the fulfillment of the objectives of internal control (as defined in art. 2 (2). 5 letter. (d) of Regulation No. 18/2009) and the related internal control framework ensures effective and efficient operations, risk control, carrying out the activity, the credibility of financial and non-financial information and compliance with the legal and regulatory framework, the surveillance requirements and the credit institution's internal rules and decisions.

A proper framework for internal control involves checking the policies and internal control procedures by the control functions / independent functions of the internal control system. These are: the risk control function, the compliance function and the function of internal audit. At the credit institutions with a less complex or smaller size, risk control function and the function of compliance can be combined.

- The risk control function is the main control function of the internal control system. Unlike the previous view of the risk control function, provided by regulation 18/2009 (this is mainly to ensure the compliance with the policies in the field of risks, usually being organized on business lines), GL 44 develop this function, assuming the risk management function characteristics of Regulation 18/2009. Thus, the risk control function in GL44 acceptation has the following features:

- the function must ensure that each significant risk faced by credit institution is identified and managed according to the relevant structures within the credit institution and as an overview (*holistic view*) of all the risks is sent to the management structure;
- the function should be organized centrally within the credit institution and must be structured so they can implement risk policies and can control the administration framework of the activity. Although large institutions with sophisticated activity may consider establishing a risk management function on each line of activity, there must be a centralized function (including, if necessary, a risk control function at group level within the group's mother credit institution) to provide an overview of all risks;
- the function's role is complex. It has to be actively involved from the initial phase of the development risk strategies and in all management decisions of significant risks. It also needs to have a fundamental role in ensuring the existence of an effective risk management process;
- the credit institution must appoint a person, CRO (Chief Risk Officer), with an exclusive responsibility for risk control function and for monitoring the risk management framework, except when the size, organization and nature of activities do not justify such responsibilities to a person specially designated for this purpose.

➢ In terms of business continuity (component of the management framework activity), there are the following issues:

- credit institutions must establish a solid process in terms of management in order to ensure the ability to operate on the principle of sustainability/continuity and to limit casualties in case of a severe business interruption;
- in order to establish a solid business continuity management, credit institutions need to consider exposure to severe disruptions of the activity and to analyze the potential impact of these, using internal and external data and scenario analysis;
- based on the analysis, credit institutions must dispose of:
  - plans for unpredictable situations and for activity's continuation – in order to ensure a proper response to emergency situations and the ability to maintain the most important activities in case there is an interruption of normal business procedures;
  - recovery plans for critical resources – to allow them to return to normal business procedures in an appropriate time frame.

➢ GL 44/2011 defines the tolerance or appetite for risk to describe on both the absolute risks a credit institution is willing to undertake (this is called appetite for risk), as well as the actual limits within the risk appetite of a credit institution (this is called tolerance to the risk).

B. The new rules imposed by the CRD IV – Directive 2013/36/EU

➢ Defines the management body for the purposes of Regulation No. 18/2009 and the GL 44. Includes in addition a number of issues related to the two functions of the management structure.

➢ Unlike the GL 44 and of Regulation No. 18/2009, also defines the governing body in its surveillance function and superior leadership.

➢ As in the system of Regulation No. 18/2009 (article 12, paragraph 1), the management structure must approve and periodically revise the strategies and policies on risk-taking, administering, monitoring and mitigation of risks to which the credit institution is or might be exposed, including those due to the macroeconomic environment in which it operates in conjunction with the stage in the business cycle (article 76, paragraph 1). There is not such a requirement in GL 44, but there's a provision according to which the management structure must establish and revise the general business strategy, as well as the general policies and strategies of risk for the credit institutions (B.1.8. points 2 and 3).

Also, GL 44 contains the provision according to which, in the decision-making process for risk management framework trends and relevant data of the macroeconomic environment must be addressed in order to identify their potential impact on the exposures and portfolios.

- Unlike the Regulation No. 18/2009 where there's a brief request that members of management structure must devote sufficient time to fulfill their obligations and responsibilities (article 18 paragraph 5 e), CRD IV requires that the management structure to allocate sufficient time to analyze/to consider the issues related to risk, in order to be actively involved in managing all risks, as well as in the valuation of assets, use of external ratings and internal models related to those risks (article 76 paragraph. 2). GL 44 tackles these provisions in general and not in strict reference to risk. So, the members of the management structure should have only a limited number of mandates or other occupational activities which require long time dedication; as President or leader has more responsibilities and powers, it must devote more time to resolve them, etc. (B. 2.12 points 2, 3 and 4). GL 44 mentioned that every person in a credit institution (not only the leadership as CRD IV) has to be fully aware of his attributions on risk management.
- The provision, found in the Regulation No. 18/2009 (article 8 paragraphs 1 and 2), according to a credit institution must establish reporting lines to the management structure which will cover all significant risks and risk-management policies and their modifications (article 76 paragraph 2) is also found in GL 44 – the organizational structure does not need to affect the ability of the management structure to oversee and effective manage the risks faced by the credit institution or group of which it forms part (A. 4. 1 and 3). Plus, credit institutions must establish mechanisms for the regular and transparent reporting, so the leadership structure and all the relevant structures of a credit institution to be provided timely reports, and these mechanisms lead to identifying, measuring or assessing and monitoring risks.
- While the Regulation No. 18/2009 indicated only the possibility of the establishment of the risk management committee, whose duties and composition are to remain at the discretion of credit institutions (article 12 paragraph 2 and article 851 paragraphs 1 and 2), CRD IV indicates the obligation of establishing a risk Committee for credit institutions which are significant from the point of view of size, internal organizing, the nature, extent and complexity of their business (also indicating its structure and functions), or the permission of combining risk with the audit Committee, if the credit institution is not significant (article 76 paragraph 3). GL 44 also speaks of a risk committee, but the same as the Regulation No. 18/2009 this is also an optional committee (B.2. 14 points 6-8 and 12).
- As GL 44 (B.2.14 point 12), CRD IV also indicates access of the management structure or of the risk Committee to information concerning risks and, if necessary and appropriate, to the risk management function and to the expert advice from outside the credit institution (external expert advice) (article 76 paragraph 4. 1). Such information emerged indirectly from the Regulation No. 18/2009 (article 84 paragraph 3 and art. 90 paragraph 4).
- A provision that has no counterpart in Regulation No. 18/2009 and in GL 44 is that relating to the functions of the management structure or of the risk Committee, if any, to determine the nature, value, format and frequency of the risks' information it receives. Also, an additional provision is also about the role of the Committee in providing risk policies and practices on remuneration, without interfering with the remuneration Committee (article 76 paragraph 4. 2).
- Risk management function provided by the CRD IV (article 76 paragraph 5. 1, 2 and 3) is also regulated by Regulation No. 18/2009 (article 78 paragraph 2, article 80 paragraph 2, article 81 paragraph 1 and article 92), and by GL 44.

- A specific provision of CRD IV (article 76 paragraph 5. 3) not found in the Regulation No. 18/2009 and in GL 44 (C.22 points 7 and 8) is the one according to the risk management function must be able to report directly to governing bodies in their supervisory function (*management body in its supervisory function*) any concerns regarding specific risk issues or developments affecting or likely to affect the credit institution.
- Provisions correspondent to the Regulation 18/2009 (article 90) regarding the existence of a coordinator of risk management function - *chief risk officer* – (or of any other person with superior function (senior person), when the nature, size and complexity of the activities of a credit institution does not justify the appointment of a CRO) (article 76 paragraph 5. 4 and 5 of CRD IV) are detailed on the GL 44 (D.27. points 1-5). Also, the revocation of the CRO, provided by CRD IV (article 76, paragraph 5.5) is detailed by GL 44 (D.27. 6).
- The provisions found to some extent on the Regulation No. 18/2009 (article 4 paragraph 1, article 14 paragraph 5, article 17, article 18 paragraph 5) concerning the definition, supervision and responsibility of the management structure for the implementation of a governance framework of the activity that ensures an effective and prudent management of a credit institution (article 88, paragraph 1. 1 CRD) are also detailed by GL 44 (II. 3, B.1. 8. 1, B.1. 8. 2, B.1.9. 1, B.2.12. 6, B.3.16.1 and 4).
- The provision according to which the management structure must have general responsibility for the credit institution to approve and revise its strategies (business and risk) and the activity's administration framework (article 88, paragraph 1. 2. a) is also found on GL 44 (B.1.8. 1 and B.1. 8. 2. a, b and g). It is also found in some measure on the GL 44 (B.1.8. 2.h and B.1. 8. 3) the provision according to which the management structure must ensure the integrity of accounting systems and financial reporting (article 88, paragraph 1. 2. b), as well as the provision according to which the management structure has to oversee the process of publication and communication of the information (article 88, paragraph 1. 2. c).
- The provision according to which the governing body should oversee superior leadership (article 88, paragraph 1. 2. d) has correspondent, being even detailed by GL 44 (B.1.10. 1 and 2).
- The provision according to which the governing body has to monitor and periodically evaluate the effectiveness of the management framework of the activity (Article 88, paragraph 1. 3) is detailed by GL44 (B.1. 9). Thus, the assessment will be made at least annually and will take account of any changes in the internal and external factors affecting the credit institution.
- The establishment of a Nominating Committee, including its composition and functions (article 88, paragraph 2. 1-5), is partially treated by GL 44 (B.2.14. 6 and 7), as long as such a Committee is not mandatory.
- The reporting requirement of the key indicators such as the rate of return on assets (*return on assets*) in the management framework of the activity (article 90) can be found in the general sense on GL 44. Thus, a credit institution must disclose significant information concerning the financial and operational results (F.33. 2 and 3).
- The requirement for training of the management structure's members (article 91, paragraph 9) is detailed on GL 44 (B.2.13. 1 and 6). So, according to GL 44, the leading structure members must have access to training programs tailored to their specifics, which take into account any gaps in the profile of knowledge needed by the credit institution and the actual knowledge of the members of the management structure.

- Detailed requirements concerning the existence of a broad set of qualities and skills in recruiting members of the leadership structure, including the existence of a policy to promote diversity within the leadership structure (article 91, paragraph 10).

3. Conclusions

At the end of this study, that cannot be exhaustive concerning the comparison between the previous legislation in the area of corporate governance of credit institutions and the new rules proposed by the European legislator and European Banking Authority, we can summarize the main elements of novelty brought about by the law-making progress in this domain as:

- the introduction of provisions relating to an effective corporate governance within credit institutions, meant to help prevent excessive risk and that allows the National Bank of Romania to monitor the degree of adequacy of mechanisms relating to the management of a credit institution;
- introduction of principles and standards that must be applied taking into account the nature, extent and complexity of the credit institutions' activities;
- redefinition of the management organ, of the leading organ and the supervisory function of the senior management, ensuring a better understanding of the role, duties and relationships, vertically and horizontally, between the structures of the credit institution;
- restoring the elements of a framework of rigorously designed activities, among which are found, in addition to the governing body and the organizational structure and risk management, internal control, information systems and business continuity, as well as transparency requirements;
- the necessity of promoting diversity in the composition of the management organ
- in accordance with the principle of proportionality regulates the functions of the risk management committee and nomination Committee
- the reissuing of the risk management framework at the credit institution's level, with the redefinition of its component operations, key functions for this activity, subordination and reporting relationships on risk management.

The conclusions to be made on the novelty brought by the new regulation refer in particular to the following aspects:

- in response to the global economic crisis and its devastating effects on the activity of credit institutions, the new regulation is focused in particular on the risk management for the credit institution and on the role, duties and responsibility of the management structure;
- it prefigures models of organizational structures / of management structures, stable, balanced, with clearly defined responsibilities and the real possibility of exercising their control, so as to be diminished the excessive risk taking by the credit institution as a result of any decision-making system flaws;
- the new regulation also focuses on the methods and mechanisms for rescue, resuscitation of the credit institution's activity after a possible economic shock, as well as on damage mitigation systems.

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