



Islamic Republic of Afghanistan  
Da Afghanistan Bank

## **Summary**

Da Afghanistan Bank (DAB) is issuing for public comment a regulation on corporate governance. The circulation of the regulation for comment is consistent with Article 3 of the Decree Law of Banking in Afghanistan (Banking Law), which requires that a regulation be published in the manner “best calculated to bring the regulation to the attention of the domestic banking industry.” If DAB determines that the delay in issuing a regulation that would be caused by circulating the regulation for public comment would be a “serious threat to the interests of the banking system” it may forego this requirement. In the case of this regulation, DAB chooses to circulate the regulation for public comment.

## **Purpose of rule**

The purpose of the regulation is to specify responsibilities common to the Board of Supervisors and Management Board, provide detail regarding the recommended makeup of and qualifications of the Management Board and summarize the responsibilities of the Board of Supervisors and its appropriate place in the governance of a bank.

The adoption and full implementation of this rule is generally in keeping with Principles 3, 14 and 17 of the Core Principles of Effective Banking Supervision of the Basel Committee.

## **Background and summary of rule**

Articles 22 through 26 of the Banking Law detail the prescribed form of corporate governance for banks. There are a number of reasons why a banking supervisor must have the authority to understand and assess the quality of a bank’s corporate governance. At the time of license issue, a determination has to be made that an appropriate system of corporate governance will be in place before the bank is allowed to open. As the bank begins to operate, a bank supervisor has to understand how the bank’s Board of Supervisors and Management Board will effectively control relevant aspects of risk management. Finally, through regular contact with bank management, the bank supervisor has to assure that the system of corporate governance is leveraged and modified in a flexible way to meet the needs of the particular institution.

The rule details and clarifies the various articles in the Banking Law that address corporate governance. It begins with those responsibilities that are common to both the Board of Supervisors and the Management Board. These primarily include assuring that members’ own business and personal relationships with the institution are always on

appropriate terms and conditions and that decisions of members should always be well informed.

The rule also details a typical structure for a Management Board. Generally, the members of the Management Board are full-time bank administrators or employees of the bank. For example, the minimum number of positions on the Management Board is three as per the Banking Law, so a good structure for the Management Board would include membership of the chief executive officer, chief operating officer and chief financial officer, or equivalent positions.

Finally, the rule details the primary responsibilities of the Board of Supervisors in ensuring competent management of the bank, ensuring appropriate plans and policies are in place, monitoring operations, overseeing financial performance of the bank and preventing conflicts of interest. It also details recommended committee structures that can be used to assist in carrying out these responsibilities and the special case of banks that are subsidiaries of other companies.



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**Article Ten: Corporate Governance**

**Part A — General.**

**§ 10.1.1. Authority**

This regulation on corporate governance of banking organizations is pursuant to the authority granted to DAB by Articles 22, 23, 24, 25, and 26 of the Decree Law of Banking in Afghanistan (Banking Law).

**§ 10.1.2. General goals and objectives.**

- a) This regulation aims to clarify the articles stated in the Banking Law regarding corporate governance of banks.
- b) The objectives of this regulation:
  - 1. Specify responsibilities that are common both to the Board of Supervisors and the Management Board.
  - 2. Provide detail regarding recommended makeup and qualifications for members of the Management Board.
  - 3. Detail the responsibilities of the Board of Supervisors and its appropriate place in the governance of a bank.
- c) Adherence by banking organizations to the standards set by this regulation will be monitored by DAB through on-site examinations.

**Part B — Board of Supervisors and Management Board**

**§ 10.2.1. Responsibilities Common to the Board of Supervisors and Management Board.**

- a) It is the duty of the Board of Supervisors to oversee the management of the bank's activities, and the duty of the Management Board to carry out the policies established

by the Board of Supervisors. Members of the Board of Supervisors and Management Board must exercise reasonable care in governing the institution's affairs and must consider the institution's well-being ahead of their own.

- b) The same person may not serve on more than one of the following boards: Board of Supervisors, Management Board and Audit Committee. The Chief Executive Officer may attend meetings of the Board of Supervisors, but only as a non-voting observer.
- c) Members of the Board of Supervisors and Management Board must ensure that their own business and personal relationships with the institution, as well as the institution's ties to other board members and Management Board, are always on terms consistent with those the bank grants to persons who are not board members or members of the Management Board. They should take appropriate precautions in structuring their business and personal ties to the bank to avoid even the appearance of a conflict of interest. While it is impossible to specifically define every practice or condition which would fall under the category of conflicts of interest, the following are examples of objectionable practices:
  - i. Engaging in transactions that would not be in compliance with DAB Regulation No. Four on Credit Extended to Related Persons issued pursuant to the Banking Law;
  - ii. A board member's or management official's taking advantage of a business opportunity for his or her own personal benefit when that opportunity is within the lawful powers of the institution and would be beneficial to the institution given its financial, managerial and technical capabilities; and
  - iii. Payment of excessive compensation or dividends to institution insiders given the bank's size or level of capital or earnings.
- d) Members of the Board of Supervisors and Management Board must make decisions within the areas of responsibility of their respective boards on an informed basis. In the case of the Board of Supervisors, this does not mean that the members need to have expert knowledge of the banking or financial services industries. However, they must gain a basic understanding of banking, the financial services industry generally, and the laws, DAB regulations and policies that affect their activities. They must also stay informed of their bank's condition through regular attendance at meetings of their boards and review of reports and materials provided there, and must exercise independent judgment in decision-making.

#### **§ 10.2.2. Management Board.**

- a) Members of the Management Board will typically be full-time bank administrators or employees. Each member of the Management Board does not necessarily need to have expert knowledge or expertise in every area of bank management, but should be generally familiar with each relevant area, in addition to having detailed knowledge

of his or her own area of responsibility, so that the members of the Management Board can work together effectively and professionally.

- b) The Management Board must be made up of a minimum of three members. Typically these three members would be the primary management officers of the bank—the chief executive officer, chief operating officer and chief financial officer, or equivalent positions.

### **§ 10.2.3. Board of supervisors.**

The Board of Supervisors is elected by the General Meeting of Shareholders of the institution, and a majority of the supervisors shall not be shareholders, management or employees of the Bank. Shareholders, whether legal entities or natural persons, may appoint representatives to the Board and these representatives may constitute a majority of Board members.

The Board of Supervisors is ultimately responsible, and is accountable to all stakeholders (including the General Meeting of Shareholders, depositors, and DAB) for the conduct of the bank's affairs and condition. Although the board members cannot guarantee success, they are expected to supervise bank operations to ensure that they reflect sound planning, are effectively governed by comprehensive policies and internal control procedures, and are administered by competent management. While the Board of Supervisors may depend upon the Management Board's technical, industrial, and managerial expertise to run the bank's day-to-day operations, the board members remain responsible for ensuring that those operations are properly controlled, comply with the policies adopted by the Board of Supervisors and applicable laws and notifications, and are consistent with sound banking practices.

In meeting its overall commitment to the bank's General Meeting of Shareholders, depositors, and community, the Board of Supervisors must:

- a) Ensure competent management.
- b) Ensure that appropriate plans and policies are in place.
- c) Monitor operations, ensure adequate internal controls and compliance with laws and decisions.
- d) Oversee financial performance of the bank.
- e) Prevent conflicts of interest.

### **§ 10.2.4. Ensuring Competent Management.**

The Board of Supervisors hires the bank's executive officials, and must actively oversee the selection process. This includes developing strategies to attract and retain competent management and staff, such as appropriate compensation packages and training programs, developing a management succession policy to address possible vacancies, and determining the circumstances under which it is necessary to dismiss members of management for poor performance, dishonesty, conflicts of interest, or other reasons. The board should institute a formal performance appraisal process.

### **§ 10.2.5. Ensuring Appropriate Policies and Procedures.**

The Board of Supervisors must adopt and approve written policies and procedures that direct management on all significant banking activities and the management of risk, including what banking practices and levels and types of risk are acceptable. All major areas of the institution's business should be covered by appropriate policies and procedures, which must be in place before any new activity is begun.

Each bank should have written policies in at least the following areas:

- Loan Approval
- Loan Review
- Asset / Liability Management
- Investments
- Code of Ethics / Conflicts of Interest

The policies should establish clear standards, but be flexible enough to allow for innovation and responsiveness to changing business conditions. Associated procedures should detail how the policies will be implemented and include steps for getting appropriate board approval for exceptions.

### **§ 10.2.6. Monitoring Operations, Ensuring Adequate Internal Controls and Compliance with Laws and Regulations.**

- a) In addition to establishing and approving the bank's policies and procedures, the Board of Supervisors must ensure that the Management Board implements the policies and procedures, as well as any corrective actions recommended (or required) by DAB. To achieve this goal, the Board of Supervisors should ensure that management incorporates a sound system of internal controls into the bank's day-to-day operating procedures.
- b) The Board of Supervisors should require periodic briefings and written reports from the Management Board regarding the financial condition and operation of the bank, and recommendations for maintenance or improvement. The Board of Supervisors should closely examine such reports and recommendations to verify their accuracy and feasibility.
- c) The Board of Supervisors or its committees must review and, if necessary, revise policies and procedures at least annually to ensure that they remain adequate and consistent with the bank's goals.
- d) The board should hold frequent, regularly scheduled meetings (no less frequently than monthly) in order to properly monitor the bank's operations. Special meetings should also be held if circumstances arise that warrant the board's immediate attention

between regularly scheduled meetings. At all board meetings, complete minutes should be taken to record significant decisions and discussions.

### **§ 10.2.7. Overseeing Financial Performance.**

The Board of Supervisors should regularly review and evaluate the bank's financial statements and certain key financial ratios, including:

- Return on Assets;
- Return on Equity;
- Net Interest Margin;
- Non-Interest Expense to Average Assets;
- Capital to Average Assets;
- Non-Performing Loans to Total Loans;
- Write-offs to Average Total Loans.

The board's responsibilities to supervise the financial operations of its bank are not diminished by the activities of the examiners of DAB. The board is independently responsible for the bank's financial condition and may not rely on the examiners to identify or correct problems. The board should expect its auditors and the Management Board to assist it in identifying any problems the bank may be experiencing.

### **§ 10.2.8. Prevention of Conflicts of Interest.**

To achieve the goal of ensuring that the personal interests of members of the Board of Supervisors and Management Board do not conflict with the best interests of the bank, the board should:

- a) Establish and adhere to a written policy on salaries, fees, loans, and expenses granted to insiders of the institution, especially members of the Board of Supervisors and Management Board;
- b) Consult with the bank's legal advisors before entering into or approving transactions involving the bank and members of the Board of Supervisors or Management Board;
- c) Disclose all real or potential conflicts of interest to the entire Board of Supervisors, and possibly to the General Meeting of Shareholders, before the board makes a decision on the matter.
- d) Ensure that the board fully documents the action it takes in approving all transactions between the bank and any member of the Board of Supervisors or Management Board.
- e) Ensure that a board member with a potential conflict of interest in any matter refrains from discussion, voting, or any other involvement in the matter and that this action is documented in the minutes.

- f) Ensure that the bank's interests are paramount in any transaction involving an insider or a related legal person of the bank.

### **§ 10.2.9. Committees.**

The Board of Supervisors should establish committees to handle matters that require detailed review or in-depth consideration. The board should consider carefully the extent and nature of the demands that will be placed upon it and should identify areas that committees could more appropriately address. The full Board of Supervisors, however, remains responsible for overseeing the financial condition and operation of the bank. All committees should have clear written statements of their missions, authorities, and responsibilities. Committees should report regularly to the full Board of Supervisors. The board should exercise the same type of oversight of its committees as it does of the Management Board and management.

The Board of Supervisors should give consideration to creating the following committees:

- a) Audit Committee

The Audit Committee monitors compliance with supervisory board policies and with laws and regulations. It should also monitor management's efforts to correct deficiencies discovered in an audit or a supervisory examination. The Audit Committee, a subset of the Board of Supervisors, is distinct from the Audit Committee that must be established according to the Banking Law. The Chief Internal Auditor of the bank should report directly to the Board of Supervisor's Audit Committee.

- b) Loan Committee

The loan committee ensures that the bank's lending policies are adequate and that lending activities are conducted in accordance with bank policy and with relevant laws and regulations. The board may also provide that the committee must approve credits exceeding a certain amount. The loan committee also monitors loan portfolio quality, ensures that management follows the board's procedures to identify problems early, recognize adverse trends, take appropriate corrective actions, and maintain proper risk classifications and provisions.

- c) Investment/Asset Liability/Risk Management Committee

The investment committee ensures that the bank's investment policies are appropriate given the size and financial condition of the bank and the capabilities of its management personnel, and that the bank's investments comply with the policies set by the Board of Supervisors and applicable laws and regulations. The investment committee evaluates the investment portfolio activity to ensure that the bank's objectives, including portfolio diversification, asset quality, and liquidity, are met. The committee may assign authority

for executing investment transactions to management. However, the Board of Supervisors remains responsible for ensuring that management carries out the institution's policies.

An asset-liability committee may be established in place of or in addition to an investment committee. The asset-liability committee oversees the bank's entire balance sheet, monitoring the interplay between assets and liabilities, to ensure that the asset - liability management policies established by the Board of Supervisors are adequate and are being adhered to.

At some banks, the investment or asset liability committee has been replaced with a broader risk management committee.

d) Compensation Committee

The compensation committee provides oversight of remuneration of senior management and other key personnel and ensures that compensation is consistent with the bank's culture, objectives, strategy and control environment.

e) Nominations Committee

The Nomination committee provides an assessment of board effectiveness and directs the process of renewing and replacing board members.

**§ 10.2.10. Banks That Are Subsidiaries of Other Companies.**

The Board of Supervisors of a bank that is a subsidiary of another company must remain aware of the activities and conditions of its parent company and that company's other subsidiaries, and in particular any activities of those companies that could adversely affect the financial condition or the public perception of the bank. These may include, for instance, large management fees or servicing fees charged to the bank by one of these companies, pressure for excessive dividends, or requests that the bank purchase poor quality assets from related legal persons.

If the parent company is engaging in practices that the members of the Board of Supervisors fear may harm the bank, the bank's Board of Supervisors should ask the parent company to respond to these concerns. If the bank's Board of Supervisors is not satisfied that the parent company's actions are appropriate, members should dissent on the record (in the minutes) and consider action to protect the bank.

**Part C — Effective date of regulation.**

**§ 10.3.1. Publication in the Official Gazette.**

This regulation will become effective one calendar month following its publication in the Official Gazette.