Jaime Caruana: Basel II and corporate governance issues

Speech by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, at the 2nd Islamic Financial Services Board (IFSB) Summit 2005: The Rise and Effectiveness of Corporate Governance in the Islamic Financial Services Industry, Doha, 24 May 2005.

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Introduction and overview

I would like to thank His Excellency Governor Abdulla Khalid Al-Attiya and the Qatar Central Bank the hospitality and Professor Rifaat and the Islamic Financial Services Board for inviting me to speak this evening before such a distinguished gathering. It is a great honour for me to be here at what I am sure will be a most successful and rewarding Summit. I consider it a privilege to have the opportunity to share with you some thoughts on two timely and important topics: corporate governance and the Basel II capital framework.

My contribution to this important conference comes with a degree of humility. Although I understand that some of the roots of Islamic finance can be traced back to my own country during the time it was known as al-Andalus, I cannot claim to be an expert in Islamic finance, and I certainly would not presume to talk about the specificities of Islamic banking before such a knowledgeable audience.

Suffice it to say that we all know that there are differences between Islamic banking and what we normally refer to as “conventional” banking. However, I do think that we share some important broader perspectives, particularly in relation to the two issues I will address today. More rigorous risk management anchored in strong corporate governance, enhanced transparency and sound minimum capital requirements that reflect the risks that banks face are vital elements for any financial system to promote confidence and foster financial stability. On top of that, common standards in these areas can help to improve the integration of the international financial system.

It is certainly true that the special features of Islamic banking may not be fully addressed by the traditionally broad international standards developed by organisations such as the one I chair – the Basel Committee on Banking Supervision. I believe that it would be neither appropriate nor possible for the Basel Committee to seek to fill such gaps. That is why I am very pleased to see organisations such as the IFSB addressing issues related to the soundness and stability of the rapidly growing market for Islamic financial services worldwide. The exposure drafts that you have issued with regard to risk management and capital adequacy for institutions offering Islamic financial services help to fill a very important niche, as will your forthcoming exposure draft on corporate governance, and your work on the supervisory review process and on transparency and market discipline.

The Basel Committee is an outward-looking committee, with a key interest in relevant matters that reach beyond its own technical and geographical borders. I am personally committed to enhancing our co-operation with non-member countries and with organisations that have related interests. In this respect, I am confident that the fruitful dialogue that has already begun between the Basel Committee and the IFSB will continue to be successful and mutually rewarding in the future.

My talk this evening will address several issues. First, I will talk about why I believe sound corporate governance plays such an important role in bank safety and soundness and financial system stability. Second, I will share some thoughts on how the Basel II capital framework will contribute to better corporate governance. Finally, I will share some of the work that the Basel Committee has underway with regard to bank corporate governance.

Why does corporate governance matter for banks and bank supervisors?

Before I talk specifically about the corporate governance of banks, I would like to discuss more generally some of the weaknesses in corporate governance that have led to high-profile failures such as Enron and Parmalat over the past few years. While every situation is unique, and in some cases not all of the facts are known, many of the recent corporate governance breakdowns appear to have several factors in common:

- The board of directors failed to understand the risks that the firm was taking, and did not exercise appropriate oversight or questioning of senior managers' and employees' actions;
- Conflicts of interest and a lack of independent board members and senior executives resulted in decisions that benefited a few at the expense of the many;
- Internal controls were either weak or non-existent, or appeared to be adequate on paper but were not implemented in practice;
- Internal and external audit "fell asleep at the switch" and failed to detect fraudulent behaviour, and in some cases even aided and abetted such behaviour;
- Transactions and organisational structures were designed to reduce transparency and prevent market participants and regulators from gaining a genuine picture of the firm's condition;
- And perhaps most importantly, the corporate culture fostered unethical behaviour and discouraged questions from being raised.

Fortunately, none of the high-profile corporate scandals of recent years have brought down banks. I would like to think that strong, effective banking supervision has been very helpful in that regard and I also believe that a sound risk management culture has become increasingly present in the banking sector in recent decades. This does not mean that we can rest; banks are not immune from any of the factors that I have just described. Indeed, if we were to look closely at bank failures large and small over the years, I believe we would find that poor corporate governance lay at the heart of many of these failures.

Why should we have higher expectations for the governance of banks than we have for other firms? Fundamentally, because banks must act in a way that promotes "confidence" to the public and the markets in general and, more specifically, to their primary stakeholders. Banks play a crucial role in the flow of capital within an economy and are charged with a special public trust to safeguard customers' wealth. A stable and healthy banking system is critical to the long-term growth of an economy.

Banking supervisors have long recognised the importance of good governance; supervision can not function properly if sound corporate governance is not in place. Experience underscores the need to have appropriate levels of accountability as well as sufficient checks and balances. For banking supervisors, although the range of topics that corporate governance may encompass is quite wide, the focus is mainly on those elements that relate to the manner in which the business and affairs of an organization are governed by its board and managers. This means the decision-making process within the bank, the respective responsibilities and accountabilities of the board and managers, the control functions that provide assurance to the monitoring processes and the structures that support all these functions.

Good corporate governance and supervisory actions complement one another. The guidance, inspections and oversight activities of supervisors cannot guarantee, on their own, the prudent operation and financial soundness of a supervised bank. Banking supervisors must rely on the competence, skills and prudence of the board and management. Confidence in the corporate governance processes at the bank will enhance the supervisor's overall confidence that the bank is being operated prudently. This may be reflected in the intensity of supervision applied. In addition, supervisors may expect a bank's governance structure to be proportionate to its size and complexity regardless of the relevant general legal requirements.

From the perspective of a prudential supervisor, the basic elements of a good corporate governance framework could include the following:

- The primary responsibility for the conduct of the bank's business lies with its board and management. Indeed, it is difficult to conceive that a bank could carry out activities in the absence of strategic objectives or guiding corporate values. Therefore the responsibilities of the board and management would include, among other things, approving ethical standards, establishing and maintaining strategic objectives, policies and procedures as well as ensuring that the bank complies with the statutory and supervisory obligations.
- Persons filling key roles should be expected to have the necessary skills and experience to carry out their tasks appropriately. The supervisor has a role in assessing the qualifications and integrity of these key personnel through fit and proper tests.

- Depending on the size and complexity of the bank, appropriate structures and control mechanisms such as strong internal audit, external audit and the oversight function of the board (directly or through supporting committees such as audit committees, risk committees, compensation committees etc) support the effective operation of a supervised bank.
- Other elements, such as the appointment of independent board members who can exercise objective judgement, are usually recognised as good practice.

Basel II and corporate governance

Let me turn now to the Basel II capital framework. I am asked to speak about Basel II quite frequently, but while I am often requested to talk about the mechanics and the impact of the new framework, I am seldom asked about its corporate governance aspects. This is unfortunate because, in my view, Basel II is fundamentally about better risk management anchored in sound corporate governance. With that in mind, I would like to focus now on three areas where I believe Basel II will contribute to more effective corporate governance. I will refer to these as the three C's: controls, culture and clarity.

Controls

The first "C" is controls. A bank can use the most sophisticated measurement tools in the world, but if it is poorly governed, it will be vulnerable to financial and operational weaknesses. The Basel Committee recognised this when it developed the qualifications that banks must meet in order to adopt the most advanced approaches under the first pillar of Basel II. The first pillar aligns minimum capital requirements more closely with banks' actual underlying risks. Qualifying banks may also rely partly on their own measures of those risks, which will help to create economic incentives to improve those measures. This presumes, of course, that qualifying banks meet rigorous criteria related to the governance of their risk management frameworks. While much attention has been focused on the more complex quantitative aspects of the new framework, I believe the most important qualifying criteria are those that address how the bank's risk management framework is governed.

Effective risk controls are essential to the successful implementation of the new capital framework. Under Basel II, the board of directors is expected to establish the institution's risk tolerances, policies, and code of conduct, and to ensure that a sufficiently strong risk control framework is in place. Senior management, in turn, is responsible for implementing the risk control framework set forth by the board. In addition, the framework sets out clear responsibilities for auditors and other quality control functions to ensure that a bank's risk control framework is subject to effective independent review, oversight and validation. The board needs to harness the work of the auditors as an independent check on the information received from management. I believe that this emphasis on the role of the board and senior management in developing and implementing an effective risk control environment will, with the help of independent audit and other control functions, result in better-managed banks.

Culture

The second "C" is culture. I believe that the increased responsibilities of the board of directors and senior management under Basel II will foster a culture of improved risk management. This notion underlies the second pillar of the new framework, which takes as its starting point that the board and senior management have an obligation to understand the bank's risk profile and ensure that the bank holds sufficient capital against its risks. Supervisors, in turn, are responsible for reviewing the bank's assessment to evaluate and determine whether that assessment seems reasonable.

The key, in my view, is that risk awareness starts at the top of the organisation. The board and senior management cannot abdicate their responsibility to understand and manage the risks arising from the bank's activities. I believe that this focus on sound risk management at the very top will help to set the tone throughout the bank that effective risk management is everyone's job.

Of course, this may also represent a cultural shift for supervisors. Basel II places a firm emphasis on taking a risk-based approach to supervision. As banks grow in complexity and sophistication, I believe that it will be necessary for supervisors to place a greater emphasis on understanding banks' own risk assessments. It is therefore vital that we complement the traditional accounting-based approach to supervision with a greater emphasis on analysis of the risks affecting banks and the control systems that banks have in place to mitigate such risks. This cultural shift may not be easy, but I believe it will be beneficial not only for us as supervisors, but also for banks and for the stability of our financial systems.

Clarity

The third "C" is clarity. I believe that Basel II will provide greater clarity regarding banks' measurement and management of risk. This will be achieved first of all through the third pillar – market discipline – which aims at ensuring that the market provides an additional layer of oversight. The third pillar is intended to focus the board and senior management on heightening disclosure, which should strengthen incentives for prudent risk management. Greater transparency in banks' financial reporting should allow majority and minority shareholders, depositors, debt-holders, and other market participants to evaluate banks and reward or penalise them according to how prudently they are managed. This should provide a window on how the bank is governed, and should serve to curb excessive risk-taking in advance.

Basel II will enhance clarity in other ways as well. Not only will banks be expected to improve their external transparency, but they will also be expected to operate more transparently internally. In particular, banks will be expected to ensure that the board of directors and senior management are sufficiently well-informed to be able to meaningfully assess the bank's risk profile. This will place a premium on effective and accurate risk reporting. Likewise, there is an expectation that senior management will communicate effectively to employees their responsibilities with regard to the effective management of risk.

Finally, Basel II will enhance clarity by promoting international co-operation between supervisors. International banking organisations have grown increasingly complex over the years, to the point that in some cases it can be very difficult for supervisors - and even for bank management - to have a clear understanding of their global risk profiles. This highlights the need for effective supervisory co-operation for such organisations. Effectively combining the necessary supervision at the local level in the host country with effective supervision at the consolidated level in the home country requires more thorough exchange of information and better knowledge of financial instruments and links within financial groups. This will heighten supervisory understanding of banks' activities and will promote consistency in the implementation of standards, a level playing field and the reduction of unnecessary regulatory burdens.

Next steps

While I have focused my remarks on the new capital framework, I would like to emphasise that corporate governance is much broader than Basel II. With this in mind, the Basel Committee has established a Working Group to review the Committee's existing guidance on corporate governance for banks.

This guidance was issued in 1999, and while the principles contained in it remain relevant, the Committee believes that this is an opportune time to review them. First, the OECD last year issued revised principles on corporate governance. Since the Committee's 1999 guidance drew upon the original OECD principles, we felt that it would be appropriate to consider their revised principles as well from our prudential perspective. Second, in light of the recent high-profile corporate governance breakdowns that I highlighted at the beginning of my remarks, we felt that it was important to consider whether there were any lessons to be learned that would apply specifically to our guidance for banks. Finally, the Committee has asked the Working Group to consider whether it would be appropriate to develop guidance on what I call "know your structure" elements.

While it is too soon to report on the Working Group's findings, they are expected to make recommendations to the Basel Committee this summer. We hope to issue a draft of revised guidance on corporate governance for public consultation in late summer or early fall. The IFSB has already expressed an interest in this work, and I certainly encourage everyone here to review the draft guidance when it is released and to send us your comments. We would like the guidance to be relevant not only to Basel Committee member countries, but to non-member countries as well. We would therefore value your feedback.

As we take our work forward in the Basel Committee, and as the IFSB conducts its own work in preparing its exposure draft, I believe we would all benefit from keeping a sense of proportion. Clearly, we cannot have the same expectations for the governance of a large, complex bank that we have for a much smaller bank. When the Basel Committee issues supervisory guidance, we typically say that supervisors' expectations should be commensurate with the size, complexity and risk profile of the institution. That applies equally here. My hope is that we can raise the bar for the governance of the banking industry as a whole, while concentrating our supervisory resources on the governance of the most complex and sophisticated institutions.

Conclusion

I realise that I am all that stands between you and a marvellous gala dinner, so I will keep my closing remarks very brief. I would just like to emphasise that sound corporate governance should be considered a key element of a bank's ability to understand and manage its risks. As supervisors, we should direct our resources to helping banks improve their controls, culture and clarity in respect to risk management. In so doing, I believe that we will help achieve our objective of a stable and healthy banking system that contributes to the proper functioning of the economy.

Thank you very much.