M R Pridiyathorn Devakula: Efficiency enhancements and risk management

Remarks by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the Asian Bankers' Seminar, Bangkok, 16 March 2006.

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Distinguished Guests,

Fellow bankers,

Ladies and Gentlemen,

Today's seminar covers wide-ranging topics of interests to the banking community ranging from efficiency enhancements to risk management needed to achieve sustainable business growth. While these issues are topical and useful to bankers, I believe that one cannot simply reduce risks by relying on risk management process alone. An effective risk management system has to be supported by proper governance of the bank's Management and its Board of Directors.

One of the painful lessons of the 1997 crisis was that improper governance practices at the Board level were amongst the root causes of the downfall of too many financial institutions. Back then, it was not unusual for banks to lend to related parties with close connections to their owners, directors, and management without the proper credit analysis. Board members of banks often neglected their responsibilities to blow the whistle against these imprudent activities. Many Board members also did not have adequate and timely access to the necessary information to detect such misdeeds so that appropriate actions could be taken to prevent the resultant damages.

The concept of "governance" as understood in Western society and now introduced into our business organizations, including financial institutions, has served as a good starting point to rectify some of the root causes of the crisis. The Western governance concept including the appointment of an independent director in the Board of Directors, the introduction of an Audit Committee, and other new initiatives to improve the governance structure, have helped to address some of the problems of the past —but only to a limited extent. Unfortunately, there have been some actual practices in the Western corporate world which are contrary to the intended ideals of good governance. The notorious examples of Enron and WorldCom are all too well-known, notwithstanding the fact that both corporations had Boards of Directors established in accordance with the Western concept of good governance. Yet both eventually faced severe financial difficulties.

As I see it, there are two critical aspects of the Western practices which may potentially lead to serious financial difficulties for the firm. The <u>first</u> is that the Chairman and the CEO is one and the same person. The <u>second</u> is the practice of allowing company stock options to be part of the compensation for company Directors. Allow me to elaborate.

A CEO is by designation the Chief of Management, responsible for achieving the best possible performance of the company. This means maximizing profits, increasing growth and market share, expanding business lines, and doing all that it takes to maximize the company's share value. On the other hand, the Board of Directors has to oversee the operations of Management, ensuring that they operate well within the bounds of acceptable risks in order to ensure business continuity. The Board of Directors, thus, needs to act as a check-and-balance against the Management with a view to ensuring the safety and soundness of the enterprise. Meanwhile, shareholders also expect the Board to perform its role as a watchdog or guarantor that the corporation would not incur losses or go into bankruptcy. They also expect the Board to check Management against excessive risk taking.

Therefore, it goes without saying that if the roles of Chief of Management and the Chairman of the Board are performed simultaneously by the same individual, then other Board members cannot fully perform their duties of providing the check-and-balance required by good governance. Worse yet, shrewd CEO will tempt other Board Members with stock options so that they would go along with his policy direction. This would especially be the case when the CEO aims for high growth or business expansion, which usually implies a quick rise in the company's equities. Though, these policies are often prone to higher risks, Board members may become less inquisitive and more optimistic in their judgment as a result of the personal interests in potential profits from stock options. At the end of the day, their own personal interests would overtake their sense of conservatism and responsibilities.

One can think of an even worse scenario when the CEO would like to cover up any wrongdoings or poor performances. Since this CEO is also chairman of the Board, he can easily influence the agenda of the meeting. Thus, Board Members may never be aware of the company's problems. If and when they have been informed of the problems, it may already be too late, as evidenced in the case of Enron.

It is for the above reasons that the authorities here in Asia, are pushing for the separation of Chairman and CEO positions so that they cannot be occupied by the same person in order to properly balance the powers and functions of the two roles. It is also fortunate for us that the practice of issuing stock options to directors of financial institutions is not yet widespread among banks in Asia.

Ladies and Gentlemen,

What I have highlighted is only one facet, and in fact only half of the story of good governance: that is what NOT to follow. Let me turn to the other issue of the missing link in the Western concept of governance.

In the Western World, the focus of the governance structure is to protect the interest of the organization and its shareholders. It ensures that the management or staff would not abuse their organisation for personal gains. However, there is nothing in the Western structure of governance that talks about the need for the protection of consumers' interests, and, more importantly, the interests of society at large.

A corporation that grows sustainably does so because it has earned the recognition of its customers. Such an acceptance comes naturally when consumers trust that the goods or services being offered by the company are of the quality that is worth their price, that they are being treated fairly and with respect; and that they do not have ill feelings towards the company. In Western society where there is great awareness for consumer protection, such ideas have therefore not been incorporated in the prescribed governance of the corporation.

In the Oriental world, however, the idea of consumer protection has not been well embedded in our culture. Hence there is a need to broaden the principle of governance to include consumer protection. In short, this means that the Board of Directors needs to oversee that the firms provide not only quality goods and services, but that they also treat their customers fairly and with respect. Indeed, the absence of a strong consumer protection standard does not give the corporations the liberty to act in their interests alone at the expense of the interests of consumers. Producers and service providers that start by caring about the interests of customers as part of the principle of non-exploitation and mutual co-existence, will find that they can maintain long standing relation and consumer loyalty.

Within the universe of businesses, the domain of financial services, particularly commercial banks, stand out as one of the most prone to abuse. As capitalist organizations, commercial banks are in a convenient position to profit directly from the general public. And this is exactly why this very sector should also place the interests of society at the forefront of their concerns. Banks' involvements in various community projects or the likes, are commendable, of course. But they also have to exercise caution not to be involved in anything which could bring about detrimental impact on society. For instance, they should take care to avoid facilitating any powers-that-be to exploit the banks or the financial market or financing projects which are clearly damaging to the environment, or partnering with businessmen in projects that take advantage of the economy.

In this context, therefore it becomes yet another duty of Board Members to also oversee that projects endorsed by the financial institution are not the kinds that facilitate the exploitation of society. It is my belief that any protection of the interests of the organizations cannot be done without the protection of the interests of society as well. The organisation can only survive if its customers are satisfied with its workings, and if the society accepts its actions.

Ladies and Gentlemen,

Allow me to end my remarks by quoting a teaching from a very senior monk who is well versed in Buddhist economic philosophy. He said that in order for an organisation (corporation) to grow sustainably, it must not exploit its employees, it must not take advantage of its customers, and it must not exploit society in which it thrives in. In so doing, the organization must ensure that it can also reward itself with a fair return so that the fruits of its labours can be fairly shared by every party concerned.

Thank you for your attention.