Caleb M Fundanga: Corporate governance and its impact on financial institutions

Remarks by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the Institute of Directors Business Luncheon on Corporate Governance and its Impact on Financial Institutions, Lusaka, 27 April 2011.

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The Institute of Directors National Vice President Mrs. Sue M. Mwaanza
The Chairman Membership and Publicity Committee, Mr. Augustine C. Seyuba
Directors and Chief Executive Officers Present
Distinguished Invited Guests
Members of the Press
Ladies and Gentlemen

I am honoured to be here today to share with you some thoughts on Corporate Governance and its Impact on Financial Institutions.

I am certain that Corporate Governance is not a new topic to all of us in this room. It is obviously of fundamental importance to this audience, given that most of you are company directors. Corporate Governance is critical to the Bank of Zambia, in its capacity as supervisor and regulator of the banking system.

Until fairly recently, corporate governance was not a topic that attracted much public attention. It was a topic reserved for discussion in the Board room or in academic environments. However, recent events, such as the Enron scandal and other corporate governance failures including events that led to the recent financial crisis, have made corporate governance a major topical issue. The recent events have highlighted the important role that corporate governance plays in a modern financial sector and the economy at large. I am therefore delighted that the Institute of Directors has chosen this topic for discussion today.

Perhaps it would be useful to begin by defining what corporate governance means. There is no single, accepted definition of what “corporate governance” means. The majority of the definitions employed by corporate practitioners relate corporate governance to “control” of the company. In this regard, corporate governance is defined as a set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed and how performance is optimised.

Ladies and Gentlemen, corporate governance is of key importance to any financial system. In Zambia the financial sector is dominated by banks and these remain the main source of finance in the economy. The failure of corporate governance in banks may therefore pose serious consequences for the banking sector and the economy as a whole. It is also important to note that the health of the financial system largely depends on their capacity to identify measure, monitor and control their risks. Banks face a wide range of complex risks in their day to day operations, including risks relating to credit, liquidity, exposure concentration, market risks, settlement, and internal operations. The nature of banks’ business particularly the maturity mismatch between their assets and liabilities, their relatively high gearing and their reliance on creditor confidence creates particular vulnerabilities. The consequences of mismanaging their risks can therefore be very severe not only for the individual bank, but also for the system as a whole.

Chairperson, it must further be noted that Banks are highly leveraged institutions, funding their assets largely from customer deposits. Banks must therefore be accountable to their depositors. The failure of a bank can therefore result in monetary loss for depositors. The interests of depositors must therefore be protected. It is for this reason that corporate governance for banks and other financial institutions is crucial and therefore the boards of directors and management of banks have to pay particular attention to the interests of depositors and other creditors.

The Basel Committee on Banking Supervision states that “effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which is critical to the proper functioning of the banking sector and the economy as a whole. Poor corporate governance may contribute to bank failures, which in turn can pose significant costs on the treasury and can have other macro-economic effects like contagion risks. Additionally poor corporate governance can lead to financial markets to lose confidence in the ability of banks to properly manage their assets and liabilities, including customer deposits, and this could in turn trigger a run on a bank or precipitate a liquidity crisis.

Furthermore, effective corporate governance is also crucial for banks since it enhances transparency. Ownership structures of banks in Zambia are varied with some banks being foreign owned, others owned by private entities while others have some degree of state ownership. Each type of ownership structure poses governance challenges. In all instances, transparency and fairness in banks’ lending and investment decisions, becomes a critical requirement.

Banks also operate on the basis of trust and therefore reputation risk becomes a critical factor that can affect a bank seriously if not properly managed. For this reason, banks need to adopt good governance practices and customer services standards in order to build public confidence in the credibility of their operations. It must be remembered that banks operate in a volatile environment where perceptions in their dealings could trigger a run on a banks’ deposits. For instance some of you in this room may remember that in 1997, First Merchant Bank Zambia Ltd, experienced a run and was subsequently closed two days later after a local newspaper reported that a customer of the bank was involved in money laundering.

Ladies and Gentlemen, the importance of the payment system to an economy cannot be over-emphasized. The payment system provides the means by which vast numbers of transactions are made each day. The payment system involves many different components, including systems for settling large, inter-bank and inter-corporate payment transactions, and systems for handling a number of smaller transactions. However, the payment system operators also face a number of risks including operational risks. In particular, they need to ensure that the systems for processing payments, the back-up arrangements, and the internal governance structures are robust. A major operational failure in the payment system has the potential to cause severe disruption to the financial system and wider economy. At its worst, a major payment system failure would bring countless commercial transactions to an abrupt halt, impede the operation of business in virtually all parts of the economy and fundamentally undermine investor and business confidence.

It is thus imperative that banks and other financial institutions as well as payment system operator maintain proper systems to enable them to identify, monitor and control risks. Sound corporate governance is the foundation for effective risk management.

The recent financial crisis has shown that the presence of a well regulated financial sector and properly run corporate entities is key to the prosperity of any economy. In particular, the crisis was caused, in part, by excessive exposure concentration, poor credit policies and inadequate management of credit risk. These risk management failures reflect a breakdown in corporate governance. They reflect poor management of key banking risks, and poor oversight by boards of the mechanisms for managing their banks. In some cases, a lack of independent directors on the boards of banks was also a significant factor in weakening the effectiveness of boards with poor quality financial disclosures and ineffective external audit.

In Zambia, although the financial sector was not adversely affected by the crisis in a direct fashion, over the period 1995–2000, the sector experienced numerous episodes of bank failures that have had adverse effects on the confidence in the financial system. A total of ten banks were closed during this period and a major weakness noted in all the failures were the weak governance structures and practices in the banks. A close examination of the failed banks identified the following weaknesses which were common in most of them; large credit exposures, lending to connected parties, poor or absence of a credit policy, incompetent management coupled with ineffective boards, foreign exchange exposures and an absence of or inadequate risk management frameworks. In other banks, the board chairman was also the majority shareholder and the chief executive of the bank. Such basic risk management failures, to a large extent reflect a breakdown in corporate governance.

Chairperson, you may wish to note that the Zambian Banking system is stronger and properly regulated today than it was in the 1990s. The Bank of Zambia has been periodically reviewing the Banking and Financial Services Act (BFSA) to bring it up to date with international standards and current global practices. One of the areas the Banks has continued to strengthen is the corporate governance provisions to ensure that the board of directors and senior management of banks and financial institutions conduct the affairs of their institutions prudently. In particular Chapter III, Part III and IV of the BFSA deal with the boards of directors of banks and financial institutions. Under these parts:

- Every bank or financial institution is expected to have a board of directors in which shall vest all the powers of management and control and which shall be responsible for the formulation of policies of the bank or financial institution (Section 30(1);
- The Board of directors shall consist of not less than 5 members (Section 30(2);
- Every financial service provider must have a Chief Executive Officer and Chief Financial Officer who shall not qualify to hold office unless it is shown that; they are fit and proper persons, above 21 years old, have not been convicted of a felony or offence involving dishonesty, are not mentally incompetent, have never been removed from office under the BFSA, have not managed a company that has gone into liquidation or entered into a composition with creditors (Section 31);
- The majority of directors must be from outside the bank (Section 32(1);
- Directors, Chief Executive Officers and Chief Financial Officers are expected to act honestly, in good faith and in the interest of the company whilst exercising due care, diligence and skill (Section 33);
- A director is required to declare in writing to the board annually, the names and addresses of the director’s associates and full particulars of every material interest (Section 35);
- A director who (a) negligently or with intent to deceive, makes any false or misleading statement or entry or omits any statement or entry that should be made in any book, account, report or statement of the financial service provider, or (b) obstructs or endeavours to obstruct (i) the proper performance by an auditor of the auditor’s duties in accordance with this provisions of this Act; or (ii) a lawful inspection of the service provider by a duly authorised inspector appointed by the Bank of Zambia, commits an offence and is liable on conviction to a fine or to imprisonment (Section 36).

In addition to the provisions of the BFSA, there are a number of regulations in place that are aimed at enhancing corporate governance for the Financial Service Providers regulated by the Bank of Zambia, some of which are listed below;

- The Prohibition and Prevention of Money Laundering Act of 2001 (PPMLA) and the Anti-Money Laundering Directives obligate the board of directors to formulate anti money laundering policies and ensure senior management implement these policies.

- The Corporate Governance Guidelines for Financial institutions issued in November; 2006. These guidelines set forth a broad framework of fundamental corporate governance principles to guide the actions of the directors and managers of the institutions operating in Zambia. (Infact, in every letter authorizing the appointment of directors of financial institutions, the Registrar of Banks and Financial Institutions makes reference to these guidelines).

Chairperson, we are also aware that the mission of the Institute of Directors is to ensure the highest professional and ethical standards amongst directors and the boards on which they serve. Similarly, the Bank of Zambia scrutinises all persons proposed for appointment as directors and senior management as a way of ensuring that only people who are credible, fit and proper are allowed to manage affairs of financial institutions. In cases where a serving director or senior manager of a financial institution falls short of the expected standards of conduct, the Bank of Zambia has powers to cause their removal from such positions.

Ladies and Gentlemen, another important safeguard relates to the requirement for financial institutions to have in place certain board committees such as the Audit, Risk Management and Loans Review Committees. This is intended to ensure independence, transparency and accountability to board oversight over management actions. All companies should strive to ensure that such safeguards are put in place for the effective oversight of management.

Finally, allow me to congratulate the Institute of Directors for continually trying to improve professionalism and ethics in our corporate entities. This is commendable. I also wish to acknowledge the mutual cooperation that has always existed between the Bank of Zambia and the Institute of Directors. You will recall that the Institute of Directors conducted a number of seminars on core principles of corporate governance under the first phase of the Financial Sector Development Plan (FSDP).

Similarly, it is our expectation that we will continue to work together under the second phase of the FSDP in the area of developing and introducing an ethics and corporate governance code for the financial sector.

I Thank You For Your Attention