# Emmanuel Tumusiime-Mutebile: Corporate governance and banking regulation in Uganda

Address by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, to the KCB Bank of Board of Directors Retreat, Kampala, 2 November 2012.

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## 1. Introduction

Good corporate governance has become increasingly recognised worldwide as essential for the efficient functioning of market economies and to ensure that they function in the interests of the wider society, and not just those with power and wealth. The focus of corporate governance is the manner in which the business and operation of a firm is governed by its board of directors and senior management.

At the core of corporate governance is the relationship between what are often termed the "insiders" of firms – dominant shareholders and senior managers – and the "outsiders" who include small shareholders, the creditors of the firm, its employees and customers and the general public. A key objective of corporate governance is to ensure that the insiders who control the management of a firm do not abuse their control and act in a manner which is detrimental to the interests of outsiders.

Good corporate governance is even more important for banks than it is for non financial firms, for two key reasons. The first is the much greater inherent opacity of the balance sheet of banks; it is difficult for outsiders to evaluate the quality of the assets which a bank holds and, therefore, its true financial position. Secondly, the potential negative externalities of bank failures are very damaging for the economy and for society, as was demonstrated vividly by the global financial crisis.

Corporate governance in banking has certain features which distinguish it from corporate governance in non financial firms. This is because of the unique characteristics of banks, in particular the fact they are very heavily leveraged and that most of their liabilities are owed to a large number of atomised depositors who have the most to lose from abusive or negligent management. Consequently, a priority of corporate governance in banking is the protection of the interests of depositors. In addition, the corporate governance of banks attaches particular importance to the veracity of financial information.

## 2. Bank failures in Uganda and the reform of bank regulation

In the 1990s and early 2000s, Uganda's banking industry suffered a number of bank failures. Eight banks failed, forcing the Bank of Uganda (BOU) to intervene and resolve them; in some cases the failed banks were closed, in others they were sold to new owners. The primary cause of most of these bank failures was poor corporate governance. In many of the failed banks, a dominant shareholder or group of shareholders was able to exert undue influence over the management of the bank which resulted in abuses such as pervasive insider lending. The losses incurred on insider loans were the single most important contributor to the collapse of these banks. The Kenyan banking industry was also afflicted by multiple bank failures in the 1990s, with poor corporate governance playing a major role in these failures as it did in Uganda. Poor and abusive management was allowed to flourish in banks because their boards of directors were usually weak, lacking the professional expertise and often the independence and incentives to provide any effective oversight of bank management.

The bank failures of the 1990s prompted the BOU and the Government to strengthen banking regulation. Parliament enacted new legislation in 2004 – the Financial Institutions Act – which, inter alia, raised minimum bank capital requirements, tightened restrictions on insider lending and mandated the BOU to intervene promptly in failing banks before their capital is completely eroded and their depositors suffer losses. The FIA also imposes a ceiling of 49 percent on the share of a bank's equity which a single shareholder, or a group of related shareholders, can hold, in order to limit the influence of dominant shareholders, although this ceiling does not apply to shareholdings by reputable parent banks domiciled in other jurisdictions with good home country bank regulation.

But we also recognised that statutory bank regulation and supervision by a public agency cannot be expected, on its own, to guarantee the sound management of banks. Moreover, excessively heavy handed regulation, although it might protect depositors, can also stifle innovation and risk taking in banks, which would be detrimental to economic development. In a market economy, the onus for sound management, including the proper management of risks, must lie with the banks themselves. Bank regulators cannot be a substitute for bad bank managers. As such good corporate governance is an essential complement to good bank regulation and supervision.

This principle was made explicit in the Financial Institutions Act, section VII of which was devoted specifically to providing a regulatory framework for good corporate governance in financial institutions. The provisions in section VII of the FIA were supplemented by a set of corporate governance regulations which were issued by the BOU in 2005. Uganda's corporate governance regulations were influenced by the guidelines published by the Basel Committee on Banking Supervision, based at the Bank for International Settlements, which is responsible for formulating global standards for bank regulation and governance.

The corporate governance regulations in Uganda focus on four key themes:

i) The fiduciary responsibilities of the Board of Directors;

ii) The importance of independent oversight of bank management;

iii) The priority which must be attached to risk management; and

iv) The need for independent audit functions.

I would like to elaborate briefly on each of these themes.

## 3. The role of the Board of Directors

Our corporate governance regulations place great emphasis on the fiduciary responsibilities which the Board of Directors owes to the bank, its depositors and shareholders and to the wider society. The Board collectively must take ultimate responsibility for the performance of the bank and for the manner in which it conducts its operations. The directors must lead from the top. They must set the strategic policies of the bank and establish its corporate values. They must also ensure that a bank's policies prohibit corruption and conflicts of interest in the bank's operations. An important function of the Board is to define clearly the duties and responsibilities of each member of the bank's senior management.

To exercise their responsibilities, the directors themselves must be of the highest integrity and have the professional expertise necessary to understand the nature of a banking operation and, in particular, how it differs from that of a non bank company, and what that means for the fiduciary responsibilities of the directors. Our regulations also stress that an individual director cannot hide behind collective board responsibility. Each director can be held individually responsible for any failings of the bank. He or she has a responsibility to report in writing to the bank regulator – the Bank of Uganda – if he or she has any reason to doubt that the bank may not be able to meet all of its obligations to its creditors or may not be able to operate as a going concern in the future.

## 4. Independent oversight of bank management

Uganda's corporate governance regulations stipulate a clear demarcation of responsibilities between the Board of Directors and the bank management. This is a very important principle.

The Board must be able to exercise oversight of bank management and hold it to account, which will only be possible if most of the directors are independent of the bank management. This principle is often violated in the corporate world in this region, where the distinction between the respective responsibilities of directors and management is sometimes poorly understood. To ensure that the Board can be independent, our corporate governance regulations stipulate that at least half of the directors of a bank, including the Chairperson of the Board, must be non executive directors. The non executive directors should not participate in any way in the day to day running of the bank.

## 5. Risk management

The Board of Directors must take the lead in formulating effective risk management policies and procedures and in monitoring their implementation by the bank's management. In particular the Board must ensure the bank has adequate capital, in terms of both its magnitude and quality, to maintain the safe operation of the bank.

The corporate governance regulations require Boards of Directors to establish two Board sub-committees for purposes of risk management; a Risk Management Committee and an Asset Liability Management Committee. The former is responsible for the general oversight of risk management in the bank, while the latter is responsible for setting specific guidelines to manage risk, such as single loan exposure limits and loan to capital ratios. The guidelines set by the Board or its sub committees must, of course, be consistent with the regulations in the FIA where applicable. For example, the Board may approve policies which would raise the bank's capital above the minimum statutory capital requirements, but it cannot set capital requirements which are lower than the statutory minimum.

## 6. Audit function

Uganda's banking regulations emphasise the importance of the role played by independent internal and external auditors in ensuring good corporate governance, and in particular ensuring that the bank's financial statements accurately and fairly reflect the its true financial position. Each bank must have an internal auditor who is independent of the bank management and who reports to the audit committee of the Board. The duties of the internal auditor including evaluating the accuracy of financial information prepared by the bank's accounting and computer systems and monitoring management's compliance with the policies and procedures of the bank.

Boards of Directors must use the internal and external auditors as an independent check on the information that is provided by the management of the bank. I want to stress that the Board of Directors must approve the audited financial statements of the bank, before they are published; hence the Directors must have complete confidence in the competence and independence of the auditors who have prepared the financial statements.

## 7. Conclusions

Banks perform a unique role in a modern market oriented economy. When banks work well they contribute to economic growth by allocating scarce financial resources efficiently and allowing private companies and individuals to undertake productive investments which they could not fund fully from their own resources. When banks work badly, which is not uncommon, the damage is often felt throughout the economy; by depositors, firms who need credit and taxpayers. The unique nature of banks provides the rationale for prudential regulation. But it is unrealistic to expect that bank regulation alone can guarantee the efficient and safe operations of the banking system. Good corporate governance is as equally important for sound and efficient bank management as bank regulation. Corporate governance must start with the Board of Directors, setting the overall strategic policies of the bank and providing independent oversight of bank management. In particular, the directors must understand clearly their fiduciary responsibilities. They must ensure that the bank's risk management is adequate to ensure its safe operation, so that depositors funds are protected and that the financial statements provided by the bank to the regulator and the public are accurate.