Sukhdave Singh: Financial governance and economic growth

Keynote address by Dr Sukhdave Singh, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Malaysian Economic Convention "Financial Governance and Economic Growth", Kuala Lumpur, 28 September 2015.

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It is indeed an honour to be speaking to such a distinguished audience. It is also a great pleasure for me to be here this morning and join my colleagues in the Economics fraternity at this 2015 Malaysian Economic Convention.

To begin, let me share with you a story.

Twenty years ago, on 28 January 1986, the NASA space shuttle Challenger was launched. Seventy-three seconds into its flight, spectators were horrified as the space shuttle broke apart in a fiery display and disintegrated over the Atlantic Ocean. Seven astronauts died. The catastrophe was traced to the failure of a single O-ring – a simple seal at a joint on one of the rocket boosters. The O-ring failed due to the unusually cold temperatures on the morning of the launch. Relative to the highly sophisticated technologies involved in building and launching the shuttle, the O-ring was considered established technology, one with a patent history of 90 years by the time the Challenger was launched. It was as ironic as it was instructive that such a complex machine, incorporating the most advanced aerospace technology of its time, failed and combusted due to a component as trivial and basic as an O-ring.

Six years later, Michael Kremer, an economist at Harvard University, formulated the O-ring theory of economic development[1]. According to him, if strategic complementarity is sufficiently strong within a system, O-ring effects can create low-production traps. *Financial Times* columnist Tim Hartford relates Kremer's theory to the concept of weak links[2]. When systems have a strong element of interdependence, weak links begin to have a more multiplicative effect, rather than an additive effect, on the overall outcomes of the system. A musical band is only as good as its least experienced player. A dance troupe is only as synchronised as its worst dancer.

Today's economies and financial systems have undoubtedly become more intricately interlinked across agents, markets and nations. This progression brings benefits as it unlocks new synergies and uncovers diverse sources of growth. However, the increased interdependence also increases the potential for O-ring type effects. Any single component within this complex web of economic and financial relationships can become the weak link of the system, with highly detrimental effects on the system's stability and on economic growth.

The financial crisis of 2008–2009 in the advanced economies was a good illustration of an O-ring weak link, whereby a seemingly small segment of the US financial system – the subprime mortgage market – triggered an economic crisis that reverberated around the world and the effects of which are still being felt today. In many ways, the build-up of vulnerabilities that led to the crisis arose from a series of bad financial decisions made by borrowers, bankers, investors and regulators. This brings forth the importance of sound financial governance as a fundamental element of robust economies and financial systems, one that ensures that the possibility of the existence of weak links within the system is minimised.

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1 Kremer, M. (1993). The O-Ring Theory of Economic Development. The Quarterly Journal of Economics (Oxford University Press) 108 (3): 551–575.

2 Hartford, T. (2015). Teamwork gives us added personbyte. Financial Times 19 June 2015.

Today, I would like to discuss three inter-related issues relevant to the theme of this conference. First and briefly, the issue of global financial governance. Then I will focus at greater length on the relationship between financial governance and economic growth at the national level. The third and final part of my remarks will cover the governance of finance.

Global financial governance: a lack of urgency

Let me start with global financial governance. I will be brief on this as much of the discussion has been had elsewhere at various other platforms. Since the demise of the Bretton Woods system in the 1970s, while the global monetary and financial system has become more integrated and sophisticated, global financial governance has changed little. The financial crisis in the advanced economies and the years since have clearly delineated the fault lines in the global system and accentuated the dire lack of effective global financial governance. One would think that there would be a greater sense of urgency in collaborating to ensure that weak links in the system do not have wide-spread contagion. Unfortunately, there is no such sense of urgency. At its core, the global system remains uneven, unanchored and unorganised. Let me elaborate.

First, the foundations of the international financial architecture are ***uneven***. As everyone is aware, there is an over reliance on the US dollar as the reserve currency and by extension, an over-concentration of risk with the US economy and financial system. The burden of adjustment is asymmetrical across countries – between deficit and surplus countries, between debtors and creditors and between governments and the private sector. Despite the higher contribution of emerging economies to world growth, global policy priorities, decision making and standard setting remain largely the domain of the advanced economies.

Second, the system is ***unanchored*** and crisis prone. With no guideposts, automatic corrective mechanisms or coordination to facilitate adjustment, the system is prone to excesses and is perpetually facing disequilibrium conditions, resulting in persistent global imbalances in terms of both the current and capital accounts, and the unsustainable build-up of debt. With no means to correct itself, adjustments often occur through costly upheavals in the form of balance of payments or financial crises.

Third, the system is ***unorganised*** with inadequate global response mechanisms. There is neither an effective platform nor an established framework for policy coordination or for crisis containment, management and resolution. There is also no true global lender of last resort as the IMF itself has only limited resources.

This has led to the rise of governance innovations amongst many economies, including Malaysia and its neighbours. Since the Asian Financial Crisis of 1997, various initiatives have fostered stronger regional cooperation, including information sharing and alternative liquidity support arrangements that are bilateral or regional in scope. While these efforts have reinforced the region’s defences against external shocks, they have not reduced the vulnerability of individual economies to external shocks. Were the fault lines in the global monetary and financial system to widen, there is no guarantee that emerging economies like ours will not be dragged into those crevices. Given the lack of global initiatives to close those fault lines, what economies like Malaysia must do is to ensure that our house is strong. We must build-up our defences and have the resilience to withstand the volatility and headwinds created by the global economic and financial environment.

One important source of that resilience is having sound financial governance at all levels of our society: the government, the corporate sector and the household sector.

Financial governance: foundation of sustainable economic growth

Financial governance sets the stage for sound financial decision-making. Broadly defined, strong financial governance is a sum of many parts including strong institutions, efficient processes, and effective rules, regulations and norms. It affects the way financial decisions are made, including decisions relating to savings and spending, borrowing and lending, investment and profit distribution, and it is relevant to all economic agents, be they households, businesses or governments.

Soundness of financial governance is a critical prerequisite for the sustainable growth of any economy. Having said that, we also have to recognise that the process of economic growth itself is an outcome of a system that is highly complex and adaptive, and that a country's economy, polity and society – and the institutions that underpin each of these – are embedded within a complex network of interdependencies. Therefore, there cannot be a one-size-fits-all prescription of what constitutes good financial governance for all economies. Nevertheless, I do believe that we can recognise the presence or absence of good financial governance based on broad characteristics. In this regard, three key inter-related features are typically present when there is good financial governance.

Firstly, effective financial governance ensures that financial decisions ***take into account all externalities*** arising from the decisions. Financial decisions often have consequences that are not fully borne by the decision maker. Financial decisions that may appear rational at the individual level, may in fact be collectively unsustainable. For instance, corrupt practices may be optimal for the individual perspective, but they are clearly detrimental to the welfare of society and the economy. In order to avoid the misallocation of resources, these externalities have to be internalised either by aligning the incentives of the decision maker; introducing a more representative decision-making process; putting in place the appropriate institutional arrangements; having effectively enforced laws, rules and regulations; or occasionally, by societal norms.

Secondly, sound financial governance encourages discipline ***in adhering to the budget constraint***. All economic agents are bound by inter-temporal budget constraints, and adherence to it when making financial decisions is key to sustainability. This is particular relevant when the repercussions of financial decisions fall on parties who are not represented – for example, decisions that shift a large debt burden onto future generations.

Thirdly, strong financial governance has ***robust external checks and balances***. To ensure sound decision making, especially when externalities are involved, decision makers, and the decision making process, must be subjected to scrutiny by external parties. In this regard, accountability, transparency, and the empowerment of the external party to take consequential action are key to effective financial governance.

All these principles apply fully to the ***management of public finances***. Sound public financial governance is the legitimate use of authority in the management of a country's financial resources with integrity to promote sustainable development.

At the heart of it all, sound governance practices in the Government can be traced back to the concept articulated by French Enlightenment political philosopher (Baron de) Montesquieu in the 18th century. The separation of power between the legislative, executive and judicial arms of the government safeguards against authority being excessively centralised in any particular party. It is the effective separation of power that provides the checks and balances that ensure that there is strong financial governance at all levels of government. It is the effective separation of power that ensures that the decision maker not only considers his or her self-interest but also that of the society at large. It is the effective separation of power that ensures that the risk of abuse or misuse of public funds is minimized. Therefore, if you want to know the state of public financial governance in a country, the first question to ask is whether there is effective separation of power.

To a great extent, the current state of public finances reflects the past track record of financial governance in the public sector. If the state of fiscal health in the crisis-affected economies had been in a better condition, monetary policy would not have had to do so much heavy lifting, QE may not have seen the light of day, and we may now be having better economic growth. When there is an imbalance in macroeconomic policies, or when such policies are used as substitutes for structural reforms, the long-term outcomes will always be sub-optimal, not least because of the distortions and imbalances that are created.

It is certainly the case that the recent crisis has been a key factor behind the increase in government indebtedness. In the aftermath of the crisis, governments in the crisis affected economies had to use public funds to rescue troubled banks. For example, Ireland had a government debt to GDP ratio of just 24% in 2007, but due to its banking crisis and its impact on the Irish economy, that number jumped to 111% by 2011[3]. In fact, even for countries that were not at the centre of the financial crisis, fiscal spending to stimulate domestic demand was increased to offset the negative real sector shock created by the crisis. The low growth environment also reduced the tax revenues of governments, further eroding public finances. So, the crisis certainly played a role in the worsening of public finances.

But that is not the complete story. In many countries, public finances were already stretched even before the crisis. This surely says something about the state of financial governance in the public sector of these economies. In the advanced economies, ageing populations and over-generous health and pension benefits were a major source of strained fiscal positions. Although the threat of demographics to fiscal sustainability is at this juncture most imminent for countries such as Japan, Spain, Italy and Greece, where the old age populations are rising most sharply amid already high levels of debt, it is only a matter of time before many emerging market economies will also face similar issues. That includes countries in ASEAN. It is therefore imperative that the public financial governance adequately embed such longer-term considerations into financial decisions being made today.

In many emerging market economies that have endowments of resources, the state of financial governance is also reflected in how governments managed the riches that flow from these resource endowments, especially in terms of providing for future generations and saving for bad times. Sadly, there are too many examples of countries that have badly managed their resource wealth. Not only have they failed to save for the future, even their use of the resource wealth has contributed minimally to supporting sustainable economic growth, often because much of that wealth is pillaged by those responsible for its management.

The practise of good public financial governance is evidenced not just from the pattern of spending but also from the effectiveness of implementation and the achievement of outcomes. For example, education and talent development is a key priority in many countries, emerging as well as developed. Large amounts of public funds are devoted to education. On the surface, it may look like good financial governance to spend so much money on such a socially and economically desirable objective. Yet, much of that spending goes to waste if there are no accompanying measures to bring about other complementary changes such as raising standards and professionalism, addressing incentives, and ensuring that what is taught meets the needs of the economy. High spending of public funds and the persistence of mediocrity will go hand-in-hand if no one is likely to be held accountable for failure to achieve outcomes. Therefore, good financial governance must be measured in the achievement of specific and measurable outcomes. If the outcomes fall short, then tax-payer money cannot be considered to have been well spent.

When there is a lack of financial governance in the public sector, it means that government contracts are awarded based on who you know rather than who can give the best value for the money. As a result, government projects often become costly, poorly delivered and fail to provide the incentives for increased proficiency and productivity. Not only that, a pool of vested interest develops to feed on the lack of financial governance, and any threats to their privileged livelihood are met with great hostility. It is the privileged position of this vested

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[3] Source: IMF's Fiscal Monitor Database.

interest that makes government reform so difficult. The end result is that the intention to have an economy that is driven by efficiency and increasing productivity remains unattainable.

There are countries that have gotten it right when it comes to good public financial governance. For resource rich economies, Norway is one example, where since 1990, the government has put aside its oil income in a fund that at the end of 2014 was worth almost US$1 trillion[4]. The sustainability of the fund has been supported by a fiscal rule that specifies that over the course of the business cycle, the government can only spend the expected real return on the fund but it cannot use any of the fund's capital. For another example, this time of a country that does not have any significant resource endowments, Singapore is considered to have prudent public financial governance. Again the fiscal rectitude is guided by legal constraints. For example, the country has adopted a legal constraint to balance the budget over the government's term in office. It also maintains an internal discipline of keeping government spending at below 20% of GDP[5]. By comparison, most developed countries have government spending at around 40–50% of GDP. So, good public financial governance is possible, assuming there is the political will to put in place the appropriate mechanisms.

What about financial governance in the private sector? The financial crisis in the advanced economies and the years since have shown how unsustainable ***household*** finances can drag down economic growth for many years. Excessive leverage and high household indebtedness often have negative economic implications. In pondering the issue of financial governance at the individual and household level, I am reminded of Leo Tolstoy's infamous quote from *Anna Karenina*, "All happy families are alike; each unhappy family is unhappy in its own way." There are indeed numerous causes of unhappiness, but being confronted with the consequences of bad financial decisions made in the past must surely be a common cause of much unhappiness among many families.

This issue is especially pertinent in the current environment of prolonged low interest rates. Sound financial decisions are needed to ensure that households do not live beyond their means and accumulate excessive debt. This is essential to ensure the sustainable growth in consumption, rather than having debt-fuelled consumption binges followed by prolonged slumps. It is these types of considerations that have made Bank Negara Malaysia maintain a level of interest rates that we believe balances between supporting the economy and discouraging excessive risk taking. This has been supplemented with other policy tools, including macroprudential policies, to manage risks within the financial system and economy.

Therefore, it is not only national governments themselves that must practice sound financial governance, they must also promote it as a key priority within the society and not create incentives that lead to unsustainable financial behaviour among economic agents.

Turning now to the ***corporate sector***, at the surface, corporate financial governance appears to have ample checks and balances. Management is accountable to boards and boards are accountable to shareholders. For publicly listed companies, there is the market discipline of the share price taking a beating for any perceived shortfalls in financial governance.

Unfortunately, history is replete with incidences of the failure of such checks and balances, including the repeated failure of markets to impose financial discipline on corporations. Notable examples of the failure of corporate financial governance include the Carrian Group in 1983, Enron in 2001, Worldcom in 2002, and the numerous examples from the recent financial crisis. The narrow fixation on profit maximisation has, in many cases, led to the

4 Source: https://www.regjeringen.no/en/topics/the-economy/the-government-pension-fund/market-value-of-the-government-pension-f/id699635/.

5 Source: https://www.mti.gov.sg/AboutMTI/Documents/app.mti.gov.sg/data/pages/507/doc/ERC_Comm_Main-Report_Part2_v2.pdf, page 77.

misallocation of resources, including the channelling of funds towards unproductive activities for purposes of rent extraction and speculation. This harms economic growth as productive segments are under-invested in.

The functioning of markets also needs to be improved. Given the widespread abuse and attempts at manipulation, I believe that appropriate regulations, and their enforcement, can help to ensure that markets function as intended, and support the greater good of society, rather than just the greed and self-interest of the market participants.

There is one final aspect of corporate financial governance I would like to mention, and this has to do with what I consider to be one of the biggest threats to future economic growth – environmental sustainability.

The damaging effects of activities such as deforestation, over-fishing and excessive emissions on the environment, have wide-ranging implications not just on the future quality of economic activity, but on the quality of life itself. Progress has been made both in terms of regulations and the increased sensitivity of corporations to their environmental footprint. However, the progress is relatively small and developing economies are particularly vulnerable to being made the choice location for the so-called dirty industries. The pursuit of profit is a powerful motivation for corporate existence and unfortunately, it often leads to short-sighted behaviour. The ongoing Volkswagen scandal is a clear example of this. Again, it reinforces the need for sound government regulation in ensuring that financial decisions taken by corporations are not only good for those corporates but also for society as a whole.

Let me now move on to the last part of my speech, which relates to the governance of finance. After all, the availability of finance is a key constraint for economic agents and therefore, a key determinant of economic activity.

Governance of finance: anchoring finance in the real economy

The need to maintain sound financial governance of financial institutions is best demonstrated through the impact of its absence. The recent crisis is a stark reminder that weak financial governance of financial institutions can result in unsustainable levels of leverage, excessive maturity mismatches and underpricing of risk within the financial system, ultimately leading to widespread wealth destruction and economic dislocation. In the US alone, conservative estimates have placed the loss from the financial crisis at between \$6 trillion to \$14 trillion, or 40 to 90 per cent of the annual economic output[6].

In response to the global crisis, more extensive international reforms have been pursued to strengthen the financial buffers of financial institutions through, among others, stricter capital and liquidity requirements. These reforms have helped to strengthen the balance sheets of financial institutions and sustained their ability to support orderly financial intermediation. While I acknowledge the importance of these reforms, there is an even more important issue related to the overall "governance of finance". The financial crisis contains many lessons on how governance of finance failed as well as the consequences of such failure. The governance of finance relates to the behaviour of financial institutions and their determinants from the perspective of organisational arrangements, incentive structures and ethics, as well as the regulatory and market environment. When these factors are correctly aligned, the financial system plays its role in supporting sustainable economic growth; when they are not, the financial system creates risks that can potentially undermine economic growth. Central to the robust governance framework of financial institutions are strong institutional arrangements that provide effective checks and balances to facilitate sound decision-making. At the broadest level, this entails well-defined responsibilities and accountabilities,

[6] Luttrell, Atkinson and Rosenblum (2013). Assessing the Costs and Consequences of the 2007–09 Financial Crisis and Its Aftermath. Economic Letter 8(7), Federal Reserve Bank of Dallas.

underpinned by a clear separation between board oversight and management. While this may appear to be a rudimentary feature of any governance arrangement, it may be challenging in organisations that are large and have complex or opaque reporting lines, resulting in boards and senior management that are too far removed from the issues on the ground. “Too big to manage” is a real concern. In their reflection of banking practices leading up to the crisis, the United Kingdom’s Parliamentary Commission on Banking Standards found that an “unclear, complex and confusing allocation of responsibilities” among senior management had posed challenges in identifying individuals who were responsible for poor decisions and more importantly, in holding them to account[7]. This is an important lesson to keep in mind for Asia, as our financial institutions continue to significantly expand their operations across sectors and geographical boundaries.

In ensuring the effectiveness of governance structures, none is more important than having competent and committed individuals at the helm of financial institutions. The members of the board of directors must have a sound understanding of the business, the risk profile of the financial institution, and the operating environment. The board must also be ready to challenge executive management and hold it to account. This demands a combination of experience, confidence and character – elements which were found lacking among financial institutions in the recent crisis. A *Financial Times* report in 2008 found that most directors at several large and troubled institutions had no significant experience in financial services[8]. An undue deference to management by directors was also prevalent in banks such as Northern Rock, HBOS and RBS, where the boards did not adequately challenge the management’s pursuit of aggressive, high-risk strategies.

It is for these reasons that Bank Negara Malaysia undertakes rigorous and frequent supervisory engagements with the boards of financial institutions. Such engagements are crucial to developing a better understanding of board dynamics and their effectiveness in their governance role. As a matter of practice, prospective directors of financial institutions in Malaysia are subjected to close scrutiny through rigorous interviews by the Bank. This approach was also recently adopted by the UK’s Prudential Regulatory Authority[9].

Governance arrangements in financial institutions must also be reinforced by a corporate culture which values and reinforces considerations for risk, ethics and compliance at all levels of the financial institution. This starts with the right “tone from the top”, whereby the board and senior management shape the core values for the firm. A common theme in the findings across various inquiries into the crisis is a breakdown in culture, where a disregard for prudence and ethics was tolerated. In some cases, individuals bearing red flags were not only ignored, but punished. The Financial Crisis Inquiry Commission launched by the US government chronicles two such instances[10]. In Lehman Brothers, the Chief Risk Officer (CRO) was stripped of her role in risk matters after warning against too much risk in the face of growing pressure to compete against other investment banks. Similarly, repeated warnings raised by the business chief underwriter of Citigroup against large purchases of defective loans did not translate into action; instead, he was downgraded in performance reviews and subsequently demoted.

Another major component in the governance of finance is how individual incentives are influenced through compensation. The global financial crisis offers a telling display of how

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7 Parliamentary Commission on Banking Standards (2013). Changing Banking for Good: First report of session 2013–14. Vol. II, HL Paper 27-II HC 175-II (London: HMSO), paragraph 553.

8 Guerrera, F. and P. T. Larsen. Gone by the board? Why bank directors did not spot credit risks. Financial Times 25 June 2008.

9 Source: https://www.fca.org.uk/static/documents/consultation-papers/cp14–13.pdf, paragraph 7.6.

10 Financial Crisis Inquiry Commission (2011). The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States. Washington, D. C.

incentives were misaligned through the widespread adoption of compensation systems that rewarded short-term performance. In the US, loan officers at ***Washington Mutual*** were rewarded more for originating higher risk loans, while loan processing personnel were compensated according to the speed and number of loans processed, rather than loan quality. Meanwhile, ***AIG Financial Products*** compensated its employees, including risk officers, on the basis of revenues brought in rather than profits. At ***Lloyds***, incentive schemes which pressured sales staff to meet targets or face demotion also encouraged mis-selling of payment protection insurance. In all these instances, executives were inclined to focus on immediate outcomes such as revenues and sales targets in order to deliver visible results quickly, without much regard for the risks assumed. Major efforts have since been undertaken internationally to address these issues. The essence of these reforms is two-pronged: the first is a greater emphasis on the governance of the compensation framework by the board and senior management; the second is a greater alignment of compensation practices with prudent risk-taking. As risks undertaken today may materialise much later in the future, the latter entails deferring portions of compensation and subjecting them to adjustments, such as bonus-*malus* and clawbacks.

Finally, a strengthened role of market discipline can also shape the governance of finance for the better by reducing information asymmetries between the market and financial institutions. Again, regulations can play a part by enhancing the scope and quality of mandatory disclosures, such as in respect of key information relating to risk exposures, risk management policies and capital ratios. A relevant emerging trend among investors and consumers has been an increasing focus on more sustainable approaches to finance, including those which consider environmental, social and governance concerns. For example, large institutional investors, including sovereign wealth funds, have started to channel more funds to firms with sustainability commitments. Admittedly, the progress made on this front has been rather modest thus far, but it does have the potential to enable a wider range of stakeholders to determine the sustainability of finance and its role in facilitating sustainable economic growth.

Conclusion

I have not actually finished my story on the Challenger shuttle disaster at the beginning of my speech. After the harrowing accident, President Reagan formed the Rogers Commission to investigate the incident, and it was found that the accident could have been avoided entirely. The special commission reported that NASA's organisational culture and decision-making processes were key contributing factors to the catastrophic event. NASA managers had been aware of the potentially fatal flaw in the O-rings since 1977, but did not respond appropriately. And on that fateful morning, warnings from engineers about the risks of launching in the low temperatures were met with contempt, and the superiors were not adequately notified of these technical concerns.

Therein lies the importance of governance structures and how decisions are made. Governance influences decisions, and decisions shape outcomes. It is no different for financial governance. Be it financial decisions at the international or national level, public or private, corporates or financial institutions, households or individuals, sound financial governance is the bedrock of stable and robust economies. The fact that a lack of good financial governance increases the likelihood of O-ring-like accidents, with potentially devastating effects on the economy, should make sound financial governance an economic and political priority.