The Imperative of Strong Corporate Governance for Financial Stability

Address by Dr. Alvin Hilaire, Governor of the Central Bank of Trinidad and Tobago
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1. ***The global financial crisis of 2007/09 brought into sharp relief the dangers that weak governance in financial institutions can pose for economic stability.*** It is well known that a major catalyst for the crisis in late 2007 was the subprime mortgage market debacle that rapidly spilled over into more general liquidity and eventual solvency problems in the United States. The contagion effects were virtually instantaneous and quite dramatic—moving from mortgage lenders in the US to other financial firms and then quickly spreading across the globe to usher in a full blown global economic downturn. As intriguing and intertwined as they were, the purely economic and financial components behind the nuclear bomb-type mushrooming of the situation—overleveraging, closely interlinked capital markets etc.—were just part of the problem. It quickly became apparent to most observers that weaknesses in governance of financial institutions played a significant part in actively encouraging or at minimum facilitating behaviors that turned out to be destabilizing. Some analysts held the view that the governance framework—including the laws, codes of conduct, regulation and supervision—was deficient and needed to be substantially beefed up; another school of thought posited that the apparatus itself was basically sound but *implementation* of established principles was deficient. However one cuts it, the consequences of the financial crisis were vast in terms of lost output, unemployment, financial instability, and bailout costs to taxpayers across the world, and meaningful efforts were subsequently devoted to explicitly strengthening financial sector governance.

2. ***At the company level, incentive systems can foster practices that progressively sow the seeds for failure unless there is consistent and diligent oversight by Boards, shareholders and depositors.*** Broadly speaking, corporate governance refers to "a set of relationships between a company's management, its board, its shareholders, and other stakeholders…The presence of an effective corporate governance system, within an individual company or group and across an

economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy."[1] For financial institutions in particular, a solid "set of relationships" is crucial given the pervasive role that these institutions play in all facets of an economy and people's lives. Also to be taken into account is the growing complication of financial transactions in a climate where technology allows for rapid movements of funds, while abrupt changes in market sentiment can lead to large scale deposit runs. Public trust and confidence are therefore essential and good corporate governance helps to set a basis for that assurance.

3. ***The international experience over the last few years has led to major advances in strengthening the governance framework for financial institutions.*** The magnitude and reach of the global financial crisis prompted a great deal of soul searching and introspection on the part of governments and regulators as to what went wrong and how to forestall similar meltdowns in the future. In zeroing in on the potential governance fragilities that were unearthed, major legislative changes were enacted; regulation and supervision were reinforced and backstopped by more substantial penalties for violations; and collaboration among regulators was significantly enhanced at domestic and international levels. By way of example, in the US the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was passed in 2010 to, among other things: i) address risks to the stability of the US financial system in part via the creation of the Financial Stability Oversight Council; ii) end too-big-to-fail bailouts of large, complex financial institutions; iii) increase transparency and regulation for certain complex financial instruments; and iv) strengthen protections for consumers and investors.[2] More generally, the Group of 20/Organization for Economic Cooperation and Development (G20/OECD)'s *Principles of Corporate Governance* were progressively strengthened. At the same time, the creation of the Financial Stability Board (FSB) in April 2009 marked an important step in the intensification of international coordination on financial governance and

[1] Bank for International Settlements, Basel Committee on Banking Supervision, "Principles for Enhancing Corporate Governance" October 2010 available at http://www.bis.org/publ/bcbs294.htm

[2] Regrettably, just last week a new Bill was passed in the US House of Representatives that, if approved into law, could significantly roll back many of the safeguards in the Dodd-Frank Act.

stability matters.[3] Established since 1983, the Caribbean Group of Banking Supervisors has also found its work intensifying in the arena of governance, especially in light of the growing incidence of cross-border financial mergers, acquisitions and investments.

4. ***As major central banks were catapulted into the role of picking up the pieces in the wake of the financial crisis, more scrutiny is being paid to governance in central banks themselves worldwide.*** The always influential, but often laid-back, posture of major central banks (and regulators) was dramatically transformed as the financial crisis unfolded: first, because regulated banks and other financial institutions were at centre stage of the crisis; and second, because in attempting to restore order, some of the leading central banks engaged in novel and unusual transactions on a scale that was virtually unprecedented. Naturally, the exercise of such power has led to more careful examination of how central banks conduct themselves. A practical expression of this can be found in the work of the Central Bank Governance Forum, which was launched under the aegis of the Bank for International Settlements to foster the good governance of central banks as public policy institutions.[4] A 2009 report commissioned by this Forum entitled *Issues in the Governance of Central Banks* highlights the complexity and diversity of central banking functions across jurisdiction while emphasizing that adherence to broad governance principles is essential for all central banks. Such principles include: i) clear and well specified objectives to carry out their monetary policy and financial stability functions; ii) appropriate powers and resources, as embedded in legislation and operationalized in decision making processes; and iii) close alignment of objectives and incentives, especially by way of transparency about such objectives, procedures and the stewardship of resources in order to assure accountability.

5. ***Meanwhile, episodes of market manipulation and collusion also put the spotlight on the presumed integrity of well-established statistical indicators.*** It is a cold fact that dishonesty and lack of integrity have not only manifested themselves at the individual company level but also in instances of collusion among companies or among like-minded traders to manipulate and

[3] The FSB was established as a successor to the Financial Stability Forum (FSB) and brings together a number of the major central banks, international financial institutions and international financial standard setting bodies. See http://www.fsb.org/.

[4] http://www.bis.org/cbgov/.

mislead markets. The information advantage that the manipulators then gain is often a source of substantial profit. A few well publicized examples come to mind:—the widespread plot by multiple prominent banks to rig the London Interbank Offered Rate (Libor); collusion by some banks to manipulate the price of silver; and reports that an early (2 second!) lead in getting data on a consumer confidence index led to major profit advantages for a select group of firms. Investigations into such instances bring out the difficulty of uncovering manipulation especially in the absence of continuous watchfulness or verification. Just two weeks ago the Financial Stability Board conceded that despite efforts by authorities and firms to strengthen financial institutions' governance, a further series of high profile misconduct cases had come to light. As a result, the FSB concluded that more work was needed to promote ethical conduct and compliance with both the letter and spirit of applicable laws and regulations, which was critical to public trust and confidence in financial systems.[5]

6. ***Turning to Trinidad and Tobago, our financial sector plays a crucial role in mobilizing deposits from savers and channeling such funds into investments.*** The country has a relatively sophisticated financial system that reaches all aspects of national life: assets of the financial system account for 216 per cent of GDP. As a result, the average citizen takes careful note of matters relating to the health of the banks, credit unions and insurance companies that they interact with regularly. At 44 per cent of total financial system assets, commercial banks play a dominant role, while insurance company assets are also sizeable at 15 per cent. The banks, nonbank financial institutions, insurance companies and pension funds are regulated by the Central Bank. A Securities and Exchange Commission oversees mutual funds and securities activities, while the Commissioner of Cooperatives currently supervises the credit unions which provide a vital intermediation function for a large segment of the population. With an open external current and capital account, the domestic financial sector is closely integrated with the rest of the world. As a result, financial problems abroad do spill over into the domestic economy. Given their collective size, influence and international connectedness, it is critical for local financial entities to rigorously follow strong governance practices; failure to do so would add another source of deep vulnerability to their own operations and potentially to the wider financial system.

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[5] http://www.fsb.org/2017/05/fsb-sets-out-next-steps-on-work-to-strengthen-governance-frameworks-to-mitigate-misconduct-risks/ .

7. ***Episodes of financial failure in Trinidad and Tobago can be linked in part to governance issues.*** Like all other jurisdictions, Trinidad and Tobago has had its share of financial company failures. Most would have been precipitated by a worsening in economic conditions which unmasked not only fragilities in business practices but also risky investment patterns and insufficient controls. Among other instances, in the mid-1980s, 5 nonbank financial institutions that were heavily involved in funding real estate development financed by offering depositors above-market interest rates were suspended by the Central Bank. In the late '80s to early '90s the indigenous commercial banks confronted severe economic difficulties which required Central Bank support, and eventually merged operations in 1993. Most recently, in 2009 the collapse of CL Financial Limited (CLF) and related companies represented a major financial shock not only to Trinidad and Tobago but also to the rest of the Caribbean; CLF's insurance and banking subsidiaries were at the heart of the imbroglio. In all of these episodes, confidence was put to the test due to the fear of contagion while, to varying degrees, public resources were utilized in the search for solutions. But challenges create opportunities: as in the US born crisis (with the Dodd-Frank Act and stepped-up surveillance), and in Jamaica (with its significant upgrading of legislation following its own financial crisis in the late '90s), the financial problems in Trinidad and Tobago prompted improvements in legislation, oversight and self-regulation of financial institutions.

8. ***Nonetheless, the current two-layer governance framework—at the legislative/supervisory and individual company levels—needs to evolve further.*** The main bits of legislation that spell out governance requirements for financial institutions in Trinidad and Tobago are the Companies Act, which requires directors to …"act honestly and in good faith with a view to the best interests of the company", the Financial Institutions Act, Insurance Act, Cooperative Societies Act and the Moneylenders Act. Bolstering these are Guidelines issued by the Central Bank to its licensees (banks, nonbanks and insurance companies) on Corporate Governance and on determining appropriateness of persons to hold key positions in the organization ("Fit and Proper Guidelines). The governance framework for credit unions is less well defined, with more discretion left to individual credit unions on how to establish governance mechanisms and criteria for appointments to directorships and top management positions. Some financial associations also set out voluntary codes that they encourage their membership to

follow: for example the Bankers Association of Trinidad and Tobago (BATT) has its Code of Banking Practice, while the Association of Trinidad and Tobago Insurance Companies (ATTIC) outlined a Code of Ethics. A few years ago several financial and nonfinancial companies in Trinidad and Tobago came together and set out a comprehensive Corporate Governance Code (2013). Among other things, this Code put forward best practices on board composition, monitoring and performance, audits and risk management, and transparency and accountability in promoting increased disclosure. All of these efforts to improve financial sector governance in Trinidad and Tobago are laudable and move in the right direction. They do however, need to be supported by addressing remaining legislative gaps—for example in updating the Insurance Act—and by concrete actions on implementation!

9. ***At the Central Bank of Trinidad and Tobago steps are in train to reinforce governance internally and in the oversight of licensees.*** Consonant with efforts in these areas by all central banks, in Trinidad and Tobago the Central Bank is moving towards increasing transparency and strengthening procurement and other procedures. In October 2016 for the first time the Bank published on its website its 5 Year Strategic Plan,[6] in which projects for advances in governance play a key role, and in April 2017 the Bank launched its internal Whistleblower program. With respect to governance in licensees, the Bank is collaborating intensely with legislators and industry participants towards passage of a new Insurance Act that would not only improve supervisory powers, but would put more onus on boards and managers of insurance companies in the areas of risk assessment, oversight and compliance. The Central Bank's interactions with licensees is also adapting in the direction of greater focus on good governance as Inspection teams engage more actively and regularly with their Boards, internal and external auditors and risk managers.

10. ***Ultimately, financial entities must police themselves and assure that their corporate culture is founded on resolute commitments to the highest standards of integrity, transparency and proper controls.*** It merits reiterating that while legislation, supervision and codes of ethics and good practice help, in the final analysis it is up to individual institutions to embrace a strong governance culture. In this regard, boards, depositors and shareholders must embrace the

[6] http://www.central-bank.org.tt/strategic_plan.

responsibility of forging the right environment, keeping abreast of developments, and being ready to act to preserve that environment. Here, let me take the liberty of borrowing from the work of the Basel Committee on Banking Supervision to offer 7 main principles for financial institutions:[7]

i) The board has overall responsibility for the institution, including approving and overseeing management's implementation of the strategic objectives, governance framework and corporate culture.

ii) Board members should be and remain qualified, individually and collectively, for their positions.

iii) Senior management should carry out and manage the institution's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.

iv) Institutions should have an independent risk management structure—risks should be identified, monitored and controlled on an ongoing basis.

v) The internal audit function should provide independent assurance to the board in promoting an effective governance process.

vi) The institution's remuneration structure should support sound corporate governance and risk management.

vii) The governance of the institution should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

While these principles were developed for banks, they are of general applicability to all financial institutions and can be tailored to cater for differences in size and complexity of operations. Taking one specific example, credit unions in Trinidad and Tobago should utilize these guiding principles in their own operations and can seek to formalize them as the credit union legislation is being upgraded.

11. ***In conclusion, concerted vigilance is essential to ensure that governance is well established and indeed remains well entrenched among financial institutions.*** It is clear that throughout the world, the movement of money through financial institutions is a high value and

[7] Basel Committee on Banking Supervision, "Guidelines: Corporate Governance Principles for Banks,' Bank for International Settlements, July 2015. http://www.bis.org/bcbs/publ/d328.htm.

often high risk activity, complicated further by unethical practices often driven by perceived opportunities for quick riches. As we have seen, the cost of failure can be very high and may not be confined to a single entity or country. It is impossible to prevent all financial company failures, and a dynamic economic environment should actually cater for a certain number of exits and entries over time as depositors' and investors' needs change. At the same time, explicit and unwavering focus on strong corporate governance can go a long way towards minimizing problems, including those emanating from large global or regionally integrated financial institutions. Lessons from turbulent times, here and elsewhere, have resulted in a growing body of literature, experiences and avenues for collaboration that can be usefully brought to bear on how to progressively strengthen governance among financial institutions in Trinidad and Tobago.