M R Pridiyathorn Devakula: The strengths and weaknesses of the Thai financial system

Speech by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the Annual Dinner of Thai Bankers' Association, Bangkok, 24 March 2006.

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Mr. Chairman of the Thai Bankers Association,
Chairman and Director of Commercial Banks and
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Allow me to refer to my opening statement at this banquet last year. My message was a look back over 30 years ago when I first started working in a bank, I recalled an annual event which has become a tradition whereby senior managements of commercial banks and the Bank of Thailand would meet up one evening in a formal social gathering. The get together provided an opportunity for them to look back at their hard work and cooperative efforts in the past year. The gathering was not one between regulators and their supervised banks, but very much in the collegial spirit of partnership, of one sharing the same fate as participant in the financial system.

On such an occasion, the Governor of the Bank of Thailand who has been entrusted the role of sea captain would provide the steer and guidance to the financial community in moving forward with future banking trends, pointing out objectively the strength and advantage of the players in the system and the weaknesses which should be addressed.

I am therefore most thankful that the Thai Bankers' Association has invoked this noble tradition, with the intent of giving it a permanent legacy. This year marks the second year of the new tradition, and I have taken this opportunity to ask all members of the Board of Directors of banks to join us. I would like to extend my deepest appreciation and thank you for being here with us.

Ladies and gentlemen,

I have specifically requested that members of the Board of directors be present here today as I would like to have the opportunity to directly share with you some thoughts and understanding. I believe these would be valuable in enhancing your role as Board members.

First of all, let me say that I empathise with you for the significant changes and adjustments which bank directors have had to make since the crisis. On top of that, the Bank of Thailand has also issued regulations which put further burden on your oversight responsibility. These can easily irritate directors especially in light of the heavy responsibility which you undoubtedly carry given your prominent role in Thai society. The intention was not to add to the burden of the Board, but simply to ensure that the Board can fully carry out its duty of care.

I would therefore like to take this opportunity to address the key duties and responsibilities of directors. We hope that you would have a better appreciation of why the Bank of Thailand needs to call for even more on your directorship role.

But before I dwell into the topic of the duties of directors, let me take this occasion to extend to you my deepest appreciation and thanks for the tremendous efforts and cooperation you have given the Bank of Thailand in the course of the year. Your institutions have continued to lend strong and valuable support to the recovery programme for the businesses affected by the Tsunami disaster, and those affected by the violence and unrest in the three southern provinces, by extending the concessional lending programme for another year. To support the reform in the banknote management system, you have made substantial changes to your operation nationwide to take on the additional role of handling and moving banknotes. This cooperative spirit truly demonstrates a shared understanding of the benefits of reform, despite the adjustments required on your part. Last year we also had a cause for celebration with the progress made in the Data Management System which helped improve efficiency of the reporting system for financial institutions, customers, and foreign exchange transactions data. Going forward, we continue to receive full cooperation from banks in building the country's economic database. The project is expected to be completed this year.

Turning to the payments system, the ITMX project designed as infrastructure for a modern payment system, has also made tremendous stride with the full cooperation of all Thai banks. This year should mark the historic new chapter for the nation's payment system, where we would see the transfer of the payments operation function from the Bank of Thailand to the private sector. This would provide greater flexibility for the system to adapt to the fast changing modern payments system development. Moreover, the recent announcement by the Thai Bankers Association of a major reform in the price structure of various payment media, including cheques, provides an important milestone towards a more efficient payment services. The move reflects a pricing based on the cost of various means of payments which would quickly eliminate inefficiency and costs to commercial banks.

Another major achievement that calls for celebration is the significant reduction in the NPL last year. Thai banks have succeeded in bringing NPL down from 556,998 million baht, or 11.82 percent of total loans at the end of 2004, to 461,439 million baht, or 9.05 percent of total loans at the end of last year. In all, the NPL was brought down by a net amount of 95,559 million baht, the largest such decline since 2001, as a consequence of the recovery of the economy and improvement in business conditions. I am confident that this year will see an even more decline in NPL than last year. Moreover, the Financial Institution Development Fund has just completed the merging of Bangkok Asset Management Company, or BAM, with Asset Management Corporation or AMC. From April they should be able to start buying assets from banks, including foreclosed assets and NPLs which have completed court process and awaiting receivership. This should help to further speed up NPL reduction.

Ladies and gentlemen,

Let me now turn to the main topic of my talk today, the role and responsibility of bank directors.

First of all, I would like to emphasize that bank directors play a crucial role not only to the individual institution, but the directorship carries with it accountability and responsibility for the stability of the economic and financial system of the country. This broad accountability arises from the central role played by banks in the process of financial intermediation and payments system of the country. Therefore, financial institution soundness and efficiency are of utmost importance, as financial system stability depends crucially on the public confidence. Financial weakness or improper business conduct in one bank could affect the general confidence and stability of the entire financial system, thus causing systemic risk.

In light of this, bank directors must carry out their duty in overseeing that sound, proper, efficient, and progressive business practices develop in their individual banks. They must at the same time uphold their accountability for the preservation of the public interest through contributing to safeguarding economic and financial stability. Thus, bank directorship carries with it accountability not only to shareholders, but also to depositors, clients, and other stakeholders in society at large.

In the past, in carrying out its oversight role, the Board had tended to rely mainly on examination report of the Bank of Thailand and that of the bank's internal auditors to identify problems created by managements and to follow up on their resolution. However, with increasingly rapid and complex business developments, this process needs to become more forward-looking, so that preventive measures or prompt corrective action can be taken to cap any problems before it can affect the bank's soundness. Supervisory agents cannot do this job alone. The oversight of Board of Directors is needed as they are much closer to the institution and its on-going developments. For this reasons, regulators worldwide have shifted their supervisory framework to mandating that the Board of Directors take lead responsibility for overseeing the process of risk management which ensures that the banks have internal prompt preventive and corrective procedures. Supervisors or regulators role would be confined to setting the broad framework, to be supplemented with area-specific examination to help provide additional independent crosscheck. For this reason, the Bank of Thailand has called on bank directors to take on an even greater responsibility. And some of you may well be contemplating what you must do in order to discharge this broader responsibility.

Today presents a good opportunity for me to discuss with you the important principles underlying governance and responsibility of bank directorship. The Bank of Thailand has drawn out 10 key principles as follows.

First, moral and ethical foundation provides the critical pillar for long-term business continuity and financial soundness of the institution, as well as its ability to play a contributing role in society. Therefore, bank directors must champion this principle, by becoming a role model in the bank, for example, by not providing undue favour to related parties. In so doing, you will help discourage management and staff from doing so.

Second, banking and finance are businesses that are subject to regulation in order to ensure fair conduct of their fiduciary duty to the depositors and protection of the public at large by ensuring transparency and proper disclosure of information necessary for investors, society, and to ensure proper market conduct. Moreover, the regulatory framework also aims to ensure that the operation of the banking and financial system contributes positively to the national interest. Thus, it is in the interests of financial institutions to aim to play a positive role in conformity to this framework and regulation. And, in this way, the Board of directors has an important role to oversee that the institution is operating within the laws, regulations, and policy guidelines. The Board of directors should also ensure that the bank meets a high standard of transparency in its operation by ensuring proper information disclosure. This will help ensure that in terms of integrity, the bank can stand high in society, and not being seen as villains of society.

Third, directors should exercise due care to prevent the misperception of being involved in a situation of conflict of interest, and risk being seen to have compromised the bank's interest. Therefore, it would be prudent to excuse yourself from any Board consideration of issues which you may have direct or indirect interest. In fact, many directors now excuse themselves from Board meetings when such agenda come up, and such action is to be commended.

Fourth, while directors need not be involved in the day-to-day running of the bank, it is important that you be fully involved in the process of setting the strategy and key policy that determine future direction of the bank at the outset. By ensuring that directors have in-depth knowledge of key strategy and policy, they can carry out their oversight role in monitoring operation of management effectively to ensure that management performance are aligned to strategic objectives, and enable them to be able to spot occasions where management have omitted to bring a report to their attention.

Fifth, this issue may be somewhat new to some directors, and is an addition to the traditional role, the role of directors in overseeing risk management in the bank. In fact, the role of directors in ensuring that the bank does not take excessive risk in conducting business is quite a traditional one. However, today, the standard to risk management has become more rigorous and technical, with risk being categorized into credit risk, market risk, liquidity risk, interest rate risk, operational risk, and reputational risk, each with their specific risk management process set out in detail, which can all seem quite complicated and somewhat of a headache at time! The standard for managing some risks could demand the use of complex quantitative technique, which can at time be quite incomprehensible, and make directors feel uncomfortable in discharging their role, and uncertain as to how deep they must dwell into the technical aspect.

Let me offer my take on how to respond to this issue, to try and help clarify the task facing the directors.

First and foremost, banks need to set up a Risk Management Committee to assist the Board's in its oversight. The members of the Committee may be drawn from the Board only, or a combination of Board and management. The important thing is that members of the Committee must be well versed in modern risk management, someone the Board trust and have confidence, and report regularly to the Board in line with the agreed work process. The practice in some banks is to form the Risk Management Committee from members drawn from the Board and also senior management responsible for various risk areas, and the post of the Chair of the Committee is given to a Board director who will act as eyes and ears for the Board on these issues.

Once the risk management Committee has been established, the Board will be able to control risks through this Committee and define types of risks that have to be closely monitored. In addition, the Committee would also responsible for setting up measures to deal with those types of risk, including the process on risk assessment and control. The contingency plan is needed to control risks in timely manner and minimize those risks to be at the acceptable level. This includes the reporting process on risk status to the Committee and Board of Directors with simple and clear message. With such practices, the Board of Directors could fully monitor risk management with appropriate decision, supporting by the Risk Management Committee.

On the division of responsibility between the Board and the Risk Management Committee, the Committee should have authority to directly oversee all risks arising from normal course of business, while the Board of Directors should be responsible for approval of the risk management policy framework proposed by the Risk Management Committee, such as approval of aggregate exposure limit to FX risk, and individual limit by transactions and traders; maximum value at risk for interest rate risk; on credit risk, setting aggregate, individual, as well as group large exposure limit to certain types of credits and borrowers, or certain groups, to prevent over concentration.

On top of setting proper risk management framework and risk limits, the directors should also be on guard against situations where normal risk management cannot fully cover. Most important among these are: improper lending to related parties if directors or senior management; improper lending to influential personality to maintain the goodwill and relationship, improper lending to clients in exchange for the right to equity participation or to benefit sharing from their businesses; and the improper profiteering by management from large procurement projects. The directors should be alert and on the look out for such situations.

Sixth, the long-term future of a bank rests on continued acceptability from clients and society at large. Therefore, the directors must pay special attention to ensure that clients are treated in a fair manner. Of even more importance is the social perception of the bank. If there is a social perception that the bank has not conducted its business in high moral standings, or fails to look after the interest of the country, then social mistrust and sanction can lead to reputational risk, and the damage may have far reaching implications and difficult to restore. The directors can play a very important role here. Typically, high-flyer managements tend to aggressively pursue growth and profits, often at the expense of social perception. Directors, on the other hand, tend to comprise more eminent personalities, who are relatively more mature and broadly experienced than management who may have been in one profession all along.

Seventh, this principle applies to the person performing the role of Chairman. This is a simple point, but quite often overlooked, that is during the meeting, the Chairman should always try to create an atmosphere conducive for independent participation of all Board members.

It is also much more effective if the positions of Chairman and CEO are not held by one and the same person. If one individual performs both roles simultaneously, then other Board members cannot fully perform their duties of providing a check-and-balance. This is inevitable in the context of our culture which tries to avoid being disrespectful to others. Moreover, if the CEO acts as Chairman, he can easily influence the agenda and delay bringing certain issues to the attention of the Board.

Eighth, on the appointment of an independent director, an independent director should not conduct any business relating to banking operations. By doing so, it may give rise to the problem of conflict of interests. An independent director should be one who is willing to stake out an independent view honestly. However, to expect a suitable individual to have no business background or business connection at all may be somewhat too ambitious. Such requirement will screen out individuals with understanding of banking businesses to assume the duty of bank directors. The requirement about business affiliation is merely a broad and general guideline. All in all, I want to focus on certain qualities which are more imperative to achieving good governance. This must start from personal qualities, such as an affinity to be independent, individualistic with high moral grounds and integrity; and a desire to express his opinion independently and honestly.

Ninth, is the issue I raised last year on “the remuneration of Board members” which has been added to the principles of good directorship. I would like to propose that Board remuneration not be tied to the future stock price of the bank nor solely linked to profits alone. The point is that if the bonus of Board members is tied to the future stock price, it might critically affect the bank in the way that occurred in the cases of Enron or World Com. When management proposes any project that might raise the company’s stock price, although a high risk project, Board member might give less weight to the risk aspect. Thus, the check-and-balance of management power will automatically decline. Moreover, the increased price of stock may not only result from the specific bank operation, but also attributed to general improvement in economic conditions and favourable stock market environment.

If the remuneration of board members varies solely with the profits of the bank, then this could create a disincentive for board members to exercise their oversight responsibility to ensure the prudence and soundness of the bank through adequate provisioning, or prevent management from undertaking excessive risks for greater prospects of profits. Typically, a bank that runs its operations in a normal course of business is already expected to generate returns on their business or normal profits. If the entire profit is taken as base to calculate bonus for their board members, would that seem fair to the institution?

I understand that some banks are exploring ways to remunerate board members which are linked not only to the profits of the bank, but also to other factors, such as the reduction of NPL, appropriate provision of loan loss and other indicators of stability. There is still no consensus on the issue, but moving away from the model of basing remuneration solely on net profit is the move in the right direction and is to be encouraged. In fact, if we continue to explore the question with an open mind, we should be able to come up with a better and fairer model. I would like to leave you with a thought:

the part that is linked to profits should more appropriately be linked to excess return rather than normal profits.

Finally when the remuneration has been set, the Board of Directors should take care to reconsider that the amount is not unreasonably high, as the Board is in the position to be the "Role Model" of what should be appropriate practices for the bank. If the Board takes undue benefits from the institution, this would undermine its authority and set bad example for staff and management to follow.

Tenth, and final point, the success of the bank depends not only on strategy and policy direction set by the Board, but also on the capability of senior management to take on those policies and implement them. Thus, the Board must give high priority to recruiting and retaining quality senior management, including work capability, experience and vision to carry out the task. But most importantly, he or she must be of high moral integrity.

The greatest weight is given to the personal attribute of high integrity because senior bank management are continually surrounded by wealth and the temptation for huge financial gains through improper conduct. Ethic is the personal inner compass that prevents the individual from taking the wrong turn and fall into the trap of exploiting conflict of interest. It would also help the individual to stand up against such conduct by others in the bank, even those of higher ranks. Such personal ethic will also help the individual to stand up to pressures from those in position of power in the country as well as those who represent such powers who have infiltrated the operation of the bank. Such moral leadership will provide an example to bank employees to uphold the high working principle thereby helping to safeguard long-term growth of the bank.

Ladies and gentlemen,

I have no intention of "preaching to the Pope". I wanted merely to share an understanding on the role and responsibility of bank directors, and convey to you the Bank of Thailand's expectation from your directorship role. It is also a good opportunity to bring to your attention the role that the Board can play in risk management, pointing out the way in which your responsibility can be carried out which need not be unnecessarily complex yet effective, and which should allow you to fulfil your role with greater confidence. The directors who are already meeting or exceeding these principles and standards should take today's talk as confirmation of your framework, while others may find some of the points useful addition to your own practice. The direct result of such principles is the strength and soundness of your banks, and ultimately the integrity of our financial system, allowing it to better absorb shocks, both domestic and abroad.

Thank you.