Ajith Nivard Cabraal: Importance of corporate governance for the banking and financial sector

Keynote address by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the 9th South Asia Management Forum, Dhaka, 24–25 February 2007.

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What is governance and why have governance?

Governance may be said to be all about effective, transparent and accountable administration of affairs of an institution by its management, while protecting the interests of its stakeholders including shareholders, creditors, regulators and the public.

Modern Corporate Governance practices have evolved over time and different codes of best practice on Corporate Governance have been developed by various organisations. E.g. the OECD code of Corporate Governance, the Basel code of Corporate Governance for banks and financial institutions, etc. At the same time, several fundamental Corporate Governance Principles have now evolved and have received worldwide acceptance, and guidelines under each such principle have been comprehensively developed by Corporate Governance activists, practitioners, researchers, and others.

These principles generally relate to the responsibilities of the Board, Directors, Chairmen, CEOs, senior management, Board appointed committees, auditors, shareholders and regulators. Accountability, internal controls, related party transactions, conflicts of interest, information disclosures have also been extensively dealt with and targeted in the formulation of these principles.

Corporate Governance principles had its origins in the 19th century although the term Corporate Governance itself came into vogue in the latter part of the 1980s. The need to focus on good practices of Corporate Governance mainly arose as a response to the separation of ownership and control following the formation of joint stock companies. The owners or shareholders of these joint stock companies, who were not involved in day to day operational issues, required assurances that those in control of the company, the directors and managers, were safeguarding their investments and accurately reporting the financial outcome of their business activities. Thus, directors were the original targets of Corporate Governance, and practices and principles were designed to protect the interests of the shareholders from misdemeanours of directors. However, current thinking recognizes a company's obligations to society more generally in the form of all stakeholders, and it has been this new thinking that has driven the study and practice of good Corporate Governance to the levels it has reached today. Perhaps it is also such thinking that accounts for the hectic pace at which developments have taken place and are taking place in the practice as well.

Since the latter part of 2001, the very lively and often controversial debate on Corporate Governance became an even more turbulent debate as a result of the massive corporate scandals and failures that rocked the business world, namely Enron and WorldCom. Almost as a knee-jerk reaction, new laws, e.g. the Sarbanes – Oxley Act in the USA and similar laws and/or regulations all over the world were quickly introduced in a possible attempt to prevent such scandals and failures in future, and to soothe the nervous minds of investors, both local and international. But, while the "big stick" was being brandished and freely wielded, the modern thinking and realization that has been quickly but firmly evolving simultaneously has been that, achieving an outcome of good corporate behavior needs more than just a long list of rules, regulations, and big sticks.

In fact, we all have now begun to learn and understand that corporate scandals and failures are a bit like the flu. Regulators, researchers and stakeholders regularly "discover" or "invent" new vaccines to combat the menace, but the virus mutates and surfaces again in a different form or under a different strain. In the same way, notwithstanding many initiatives of the 1990s and the early 2000s, after several rounds of corporate scandals around the globe, from Enron to WorldCom to Parmalat to Daewoo to so many others, new vaccines and treatment methods had to be quickly researched, hastily prescribed, and widely administered. After the dust has settled however, we now find, when we pensively reflect, that some treatment may have been too strong or has been causing too many adverse side-effects. Some pills may have been too bitter. Some tablets may have been too expensive. Some disease management techniques may even have been more harmful than the disease! Nevertheless, in our collective endeavour to pump the patient with as many drugs and tests we could possibly administer (may be because we could avoid law suits relating to professional negligence by doing so!), a plethora of new rules and regulations have been churned out and these keep being churned out at regular intervals. But, with all that frenzied activity, the vexed question that keeps on haunting stakeholders is: Will today's regulations suffice to inoculate companies from crises in the future and keep them healthy? Will these rules help to maintain and sustain investors' trust in companies? Will these laws and regulations help to stimulate institutions instead of stifling them? Will these efforts actually build trust and confidence in the overall system? Of course, we have to readily admit that if not for the quick responses in the aftermath of Enron and others, the damage could have been too much to bear. The repercussions and loss of confidence could have been too serious to contemplate. But, at the same time, a painful truth has also emerged. i.e., that laws, rules, regulations and Codes, by themselves do not ensure good corporate behavior. However powerful and strong the new vaccines appear to be, however effective the treatment seems to be, however professional and keen the doctor tries to be, new diseases will emerge. Some may be minor. But, ever so often, new strains will occur, that will place the system under severe threat.

Arising from this realization, another fundamental realization has also dawned. i.e., good corporate behavior is ensured when companies and stakeholders genuinely believe that it is in their own best interests to act ethically and to act according to best governance practices. Enforcement is important. But we have to admit that enforcement by itself will not keep bad actors out of the theatre. We will sometimes observe that some actors are bad, only after they have performed for some time. In the same way, there cannot be a set of laws or regulations that are complete in every way so as to be able to deal with every risk prevalent in the market. Many are the instances where market participants, especially those driven by short term self interest, look for regulatory loopholes and lacuna to further their interest without being unduly bothered by the underlying prudence of their actions. Therefore, regulators have begun to acknowledge that they alone cannot guarantee that all companies will continue to advance in a safe and sound manner. Regulators have also, albeit painfully, realized that all competing parties cannot be simultaneously fully satisfied. Unfortunately however, it is in this turbulent, and sometimes even chaotic environment that we have to search for solutions.

Corporate Governance is also increasingly acknowledged as being an important instrument to address "ownership issues" as well. With the current practices that are available worldwide which can hide the identities of true owners, it is now almost impossible for regulators to only rely on ownership limits to deal with undue influence, or be assured that seemingly unrelated parties are not actually related! Consequently, markets are increasingly looking towards the application of good Corporate Governance practice to overcome any ill-effects that may arise out of ownership concentration and it is generally believed that if good governance is in place, concentrated ownership, known or unknown, may not adversely affect the risk management process of the institution. In the case of banks especially, regulatory limits on ownership in banks are prescribed in a number of countries to prevent banks from being controlled by a single owner or a group of connected owners. However, a majority of countries in the world still do not have such regulations. In fact, according to a World Bank survey of 157 countries in 2003, 112 did not have regulations on ownership limits. Nevertheless, in many countries, indirect regulations such as limits on related-party transactions and fit and proper tests for bank directors and executive officers are in place to promote this aspect of good Corporate Governance, and I think, regulators genuinely believe that such practices would increasingly ensure the better risk management of banks, thereby leading to a more sound system.

All in all, as of today, Codes of Best Practice on Corporate Governance set out principles within which values and governance rules should be set by the management of the institution, and in the final analysis, good Corporate Governance is looked to as being a key tool to be used in the overall risk management of institutions, irrespective of the nature of the business carried out by the institution.

Why is good governance in the banking and financial system more important than any other sector?

The Banking and financial sector is easily distinguishable from the others. A few distinguishing features stand out:

- Unlike normal business entities which are funded mainly through shareholders' funds, banks' business involves funds raised mainly through deposits. The business of raising public deposits places greater fiduciary responsibilities on the institution and its managers, since depositors' funds need to be safeguarded in a special way.

- Banks perform as financial intermediaries by lending and investing the funds mobilized and funding economic activities of others.
- Banks are the agents of the payments system where they facilitate payments domestically and internationally, through various instruments such as bank accounts, fund transfers, credit cards, etc.
- Banks are able to undertake all such business operations as a result of public trust and faith in the stability and soundness of the banks in particular and the system in general. The history on bank failures in many countries indicates that loss of public confidence in banks could be contagious and could easily lead to systemic banking crisis situations.

Overall, the banking business is the key for monetary conditions in a country. Bank deposit and lending business determines the supply, cost and availability of money. Money is created by the banking system through the legal tender issued by the Central Banks and/or Monetary Authorities. Since sight money created is payable by banks at any time through legal tender and technically, the banking system does not have funds adequate for meeting all such created money at any particular point of time. Banking business thus casts a huge responsibility on the monetary authorities to facilitate, regulate, and protect the banking and payments system.

Weak Corporate Governance (CG) can contribute to financial instability and that would increase the risk profile of companies in the corporate sector and expose the banks and financial institutions to a greater risk. In a more direct sense, weaknesses in CG arrangements in banks and financial institutions reduce their capacity to identify, monitor and manage their business risk and that can result in poor quality lending and excessive risk-taking by the financial institutions. Depending on the resilience of the financial institutions and markets, these risks have the potential to spread across the wider financial system. Needless to say that inadequate CG can also lead to a poor credit culture, excessive exposure concentration, poor management of interest risk/exchange risk and inadequacies in the management of connected exposures. Some of these risks, singularly or collectively, can lead to potential insolvency and financial instability.

In more recent times, the regulators world over have introduced prudential norms on single borrower exposures, group exposures and concentration of credit risks. The underlying principles of such norms indicate some degree of compulsion on the observance of CG principles. To further augment such prudential norms, regulators may even consider introducing mandatory disclosures by banks and financial institutions.

Where does good governance fit in this scenario?

Obviously, Corporate Governance is now identified and acknowledged as a powerful tool to generate trust and confidence in an institution. In that context, good Corporate Governance is essentially important for banks, because such institutions (a) deal with funds raised from the public; (b) are likely to encounter greater risks including frauds and failure; and (c) if such frauds or failures occur in such institutions, it may pose issues relating to public confidence in the financial system stability itself.

All these reasons have led to Banks tending to depend upon risk management practices based on principles of prudence rather than complying with only minimum requirements.

It is also as a result of such realization that many stakeholders and regulators are now consciously looking towards good Corporate Governance, as one of the prime instruments in its overall effort to maintain financial system stability. In Sri Lanka, the CBSL has already issued a voluntary code of best practice on Corporate Governance to banks. This was prepared by a Task Force consisting of persons from the banking and financial sector. But, we now believe that the time has come for us to move towards more stringent application of Corporate Governance Codes and therefore we are now in the process of drafting and issuing a new code of best practices on Corporate Governance to be made mandatory for banks.

What are the challenges that face regulators in dealing with the Banks?

Over the past few decades, the activities in the field of banking have been increasing rapidly and today a large number of new areas have been added to the traditional list of services provided by Banks. An examination of such lists would clearly indicate that Banks of today are performing many services that were hitherto provided by other service providers. We now see that the conventional difference between banking and other financial businesses, i.e., insurance and securities trading, has almost disappeared. In the meantime, the rapid development of debt securities markets too, has been posing new challenges to the traditional intermediation business of banks. All this has blurred the customary boundaries and there are many overlaps that have been created. Naturally these trends lead to new challenges to the Regulators of banks who now have to deal with these new multi-faceted conglomerates, instead of the traditional deposit taking/money lending institutions that were once-upon-a-time called “bank”. Therefore, today, a need has surfaced where several regulators are compelled to act as a group to undertake consolidated supervision of the financial institutions, especially financial conglomerates, and this is becoming increasingly common. Regulators now tend to enter into MOUs to share information under the current legal provisions, and they also have periodical meetings, sometimes in the form of financial system stability committees or as inter-regulatory institutions committees to assess potential systemic risks/crises and to develop crisis prevention and resolution measures. In fact, in some countries, Regulators now develop common tools to conduct financial “fire drills” to prepare for possible failures of large financial institutions, and such practices include various simulation techniques as well.

That is not all. The Regulators’ work has become even more complex due to the rapid internationalization of the banking system. Internationalization could take place in two ways: through ownership or business operations. “Ownership” involves international investors and/or international banks acquiring banks in other countries. Banking “business operations” gets internationalized through the use of modern IT where geographical boundaries and country regulatory boundaries are no longer applicable and it becomes increasingly difficult to identify a single particular location as being the operative area in respect of certain financial transactions. Modern IT and financial liberalization are the keys that have led to this type of banking internationalization. At the same time, it has provided for innovative electronic money and scripless settlements systems for cross-border financial transactions. Financial liberalization is now leading to banking internationalization where surplus funds flow cross-border to finance deficit units, i.e., international intermediation. In this background, it is now realized by Regulations that the high mobility of capital flows creates enormous risks to internationalized banks and to international systems, if the individual fund management systems of such banks are not sound. This requires Regulators to place even greater weight upon the efficacy of the governance systems since the failure of such institutions could be catastrophic to the well being of the entire global financial systems. In addition, the ill effects of money laundering, financing of illegal activities, and the financing of terrorism through the banking system are further risks that are faced by banks due to this growing internationalization. These too, need to be addressed by stakeholders who are involved in the development of the evolving systems. To deal with these challenges, Regulators now have to close ranks internationally as well, and attempt to harmonize prudential requirements to monitor risks of international financial conglomerates, and in this regard, we all must be somewhat relieved that the Basel capital accord has provided a clear framework for us to apply on the subject.

As we all know, the Basel code of Corporate Governance for banks and financial institutions covers 8 principles. These are:

- Principle 1: Board members should be qualified for their positions, have a clear understanding of their role in Corporate Governance and be able to exercise sound judgment about the affairs of the bank.
- Principle 2: The board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organization.
- Principle 3: The board of directors should set and enforce clear lines of responsibility and accountability through the organization.
- Principle 4: The board should ensure that there is appropriate oversight by senior management consistent with board policy.
- Principle 5: The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions.
- Principle 6: The board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long-term objectives and strategy, and control environment.
- Principle 7: The bank should be governed in a transparent manner.

- Principle 8: The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, those that may impede transparency (i.e. "know-your-structure").

It is very clear today, more than ever, that Regulators also have a key role to play in achieving good Corporate Governance. In general, all regulations, in the Banking System, are intended in one way or another, to enforce prudential requirements on key areas of affairs of institutions to mitigate identified risks. Regulations on ownership, related party transactions, fitness and propriety tests for directors are directly based on modern Corporate Governance principles. However, the Basel Committee goes further and describes the role of supervisors in Corporate Governance by adding new parameters as well. These are:

- Supervisors should provide guidance to banks on sound Corporate Governance and the pro-active practices that should be in place.
- Supervisors should consider Corporate Governance as one element of depositor protection.
- Supervisors should determine whether the bank has adopted and effectively implemented sound Corporate Governance policies and practices.
- Supervisors should assess the quality of banks' audit and control functions.
- Supervisors should evaluate the effects of the bank's group structure.
- Supervisors should bring to the board of directors' and management's attention, problems that they detect through their supervisory efforts.

According to Basel recommendations, Corporate Governance should be promoted by other stakeholders as well. For instance,

- Shareholders – through the active and informed exercise of shareholder rights;
- Depositors and other customers – by not conducting business with banks that are operated in an unsound manner;
- Auditors – through a well-established and qualified audit profession, audit standards and communications to boards of directors, senior management and supervisors;
- Banking industry associations – through initiatives related to voluntary industry principles and agreement on and publication of sound practices;
- Professional risk advisory firms and consultancies – through assisting banks in implementing sound Corporate Governance practices;
- Governments – through laws, regulations, enforcement and an effective judicial framework;
- Credit rating agencies – through review and assessment of the impact of Corporate Governance practices on a bank's risk profile;
- Securities regulators, stock exchanges and other self-regulatory organizations – through disclosure and listing requirements; and
- Employees – through communication of concerns regarding illegal or unethical practices or other Corporate Governance weaknesses.

In a broader sense, mandating the banks and financial institutions to adhere to full disclosures of their operations would not only allow the markets, investors, depositors and others to keep a close watch on the financial institutions, but also provide an opportunity for other regulators also to be closely involved in supervising these institutions. For example, listed banks and financial institutions are not only under the supervisory arm of the Central Banks, but also the Securities & Exchange Commissions. In multi-regulatory and multi-supervisory systems like what is still prevalent in our part of the world, it is necessary to ensure that the regulatory and supervisory burden be shared by all who are responsible for regulating and supervising banking and financial institutions. This will also provide an opportunity to mitigate concentration of regulatory risks. In multi-regulatory regimes, it is particularly relevant to ensure that appropriate CG principles are laid down, so that all regulators are aware of the principles behind these governance rules that are introduced in the interest of the wider financial system stability.

In promoting sound CG, it is also necessary to develop an effective legal framework that specifies the rights and obligations of the institution, be it a bank or a finance company or other, its directors, shareholders and other stakeholders. The regulators, on their part, should initiate action to build capacity in CG at various levels, including the chairmen, the boards of directors and senior management of banks and financial institutions. The legal framework should also provide for disclosure requirements, facilitating the enforcement of the law.

Further, it is essential to encourage an effective financial news media, which deals with the importance of CG and educate the public. They should play a more responsible role in disseminating accurate information to the public and initiating a meaningful discussion on the subject.

Conclusion

The developments in Corporate Governance that are taking place all over the world are increasingly complex. It is almost impossible for those who are not undertaking full-time studies on the subject to keep pace with these developments. Yet, all of us who are interested in systems that stimulate business and keep the wheels of economies moving at a rapid space, would continue to have a strong interest in the subject. I am also hopeful that, the banking and financial community will continue to promote and foster these studies and practices since these provide the lubrication for the smooth functioning of our complicated financial systems in our ever-changing corporate regimes.

We also know that a large portion of global business is in the banking sector. In addition, all business entities, maintain direct relationships with banks and financial institutions. In that context, the pre-eminent position that is applicable to the banks and enjoyed by them cannot be over-emphasized or under-estimated. Therefore, our efforts to enhance the governance capabilities and capacities within banks and financial institutions have to be at the forefront of our agendas. The trend in the world of targeting governance practices in the banking and financial sector to be at the cutting edge of prevailing practices worldwide is a significant step in the right direction and should continue to be so in the future as well.

Let us therefore together and collectively dedicate ourselves to promote and apply good Corporate Governance principles and practices in our respective banking and financial sectors. Needless to say, the beneficiaries of such efforts will be our own economies which we are striving to develop as quickly as possible.