Shamshad Akhtar: Corporate governance for banks

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the IBP Convocation, Lahore, 13 March 2008.

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This morning I propose to share with you my thoughts on the topical issue of "Corporate Governance for Banks". Corporate governance revolves around the basic principles of fairness, transparency and accountability. Contrary to the perception of many, good governance is not a new phenomenon – the concept of well governed companies has been there ever since formal businesses took over the barter trading system. "Corporate Governance" received fresh impetus and widespread recognition during the 1990s with launching of the Cadbury Report in the UK and prognosis of East Asian Crisis of the late 1990s and a series of corporate scandals in West including the Enron Scandals. Together the loss of investor confidence and economy generated by the corporate failures brought to forefront the significance of corporate governance. Global and regional debates and initiatives have helped promote greater fairness, transparency and accountability, though there remains scope for still better understanding of its dimensions and effective implementation.

Corporate governance is critical to improving economic efficiency and growth. It serves as a deterrent to mismanagement and infuses discipline in the decision making process of boards of directors. Adherence to the principles of good corporate governance serves to foster investor confidence and attract domestic as well as foreign investors. Companies operating on the principles of good corporate governance are able to attract investment. A study conducted by McKinsey quarterly indicated that investors would be willing to pay as much as 30 percent more for shares in companies having effective corporate governance. A number of surveys of investors in Europe and the US support the same findings and show that investors eventually reduce their investments in a company that practices poor governance.

Why corporate governance matters for banks?

The need for corporate governance in Pakistan is unmistakable. The country has steadily responded to the corporate governance challenges and progress in the banking sector is particularly impressive. Before we consider the corporate governance reforms for banks and the outstanding agenda, let us first explore why corporate governance matters for the banking system!

Most importantly, the financial system in Pakistan continues to be predominantly bank-based, with bank assets to GDP ratio of 58.8 percent for 2007. Good corporate governance for banks, therefore, becomes critical in ensuring solvency and stability of the financial system as effectively governed banks are more efficient and prudent in directing their resources.

Secondly, banks are highly-leveraged: they lend money borrowed from depositors and must therefore be accountable to these depositors. The corporate governance framework should, therefore, ensure aligning the interests of the management with equity and debt holders. The corporate governance of banks is intricately tied to the corporate governance of firms with former enforcing discipline through proper due diligence of conduct of corporate and their financial, while proper governance at corporate level help in safeguarding bank's interests.

Thirdly, ownership and group structure of banks in Pakistan is highly varied. The banking sector comprises of foreign-controlled, family-owned and some state-owned banks, with each type of ownership structure posing its peculiar governance challenges. Moreover, some banks operate as part of industrial/commercial groups while a large number of them have exposure to the non-bank financial sector through ownership and control. In such a scenario, transparency and fairness in banks' lending and investment decisions, particularly those concerning group companies, becomes a crucial requirement.

Finally, banks need to adopt good governance practices and customer service standards in order to build public confidence in credibility of their operations. Banks operate in a highly vulnerable environment where bonafide or perceived impression of malpractices in a bank's dealings could trigger a run on its deposits.

Role of SBP

SBP has been on the forefront in promoting good corporate governance in the country. Primarily as the regulator and supervisor of banks and DFIs, SBP has a crucial role in steering corporate governance reforms in the banking sector. In this regard, SBP has implemented a comprehensive corporate governance regime for banks, which is driven by a robust legal and regulatory framework, risk-based supervision and over-arching banking sector reforms, notably, privatization, liberalization and consolidation of banks.

The major thrust of legal and regulatory requirements is to strengthen the functioning of the Boards of directors of banks. In setting out the responsibilities of the Board, SBP requires directors to focus on policy making and general direction, oversight and supervision of the business of the bank. The directors are expected to meet frequently, set up Board committees for audit, risk management, recruitment and compensation, and attend training programs to help them discharge their role as a director.

In a recent move, SBP has separated the positions of chairman and CEO of banks and made it mandatory on banks to appoint on the Board at least 25% independent directors and not more than two executive directors. SBP has also strengthened the fit and proper criteria and approves appointment of directors and CEO of banks in line with the criteria. Banks must also follow the fit and proper criteria in appointing key executives although such appointments do not require SBP approval.

Recognizing the centrality of proper risk management in corporate governance framework, SBP has issued guidelines on risk management, internal controls, IT security and business continuity planning. Detailed instructions are available in the policy framework for banks. Risk management framework is laid out in the regulatory requirements that check banks' exposure to group companies and other related parties, restrict exposure to single borrower, borrowing group or sector, as well as limit banks' investments in equity market. Key requirements in this regard are:

(i) Shareholding by a bank/DFI in other companies has been restricted to 30 percent of the other company's paid up capital or 30 percent of the paid up capital and reserves of the acquiring bank/DFI, whichever is lower. (Section 23 (2) of BCO)

(ii) Banks/DFIs have been restricted from taking unsecured exposures on their directors, major shareholders, CEO, their families and firms or companies in which such persons have interest. In case a secured exposure is to be taken, it shall require prior approval of the Board of directors, excluding the director concerned, and the facility shall be extended by the bank at prevailing terms and conditions, on an arm's length basis.

(iii) Standard limits at 30 percent and 50 percent (including 20 percent and 35 percent for fund based exposure) of bank's/DFIs' equity apply on single and group exposures, respectively. Furthermore, contingent liabilities of a bank/DFI should not exceed 10 times its equity. Likewise, clean lending to single persons is limited to Rs. 0.5 million while aggregate exposure against all clean facilities should not exceed the equity of any bank/DFI. SBP has also specified that banks'/DFIs' exposure to a company cannot exceed 10 times of borrowing entity's equity and the borrower's current ratio cannot be lower than 1:1.

(iv) Banks/DFIs should not invest in shares of any company/scrip in excess of 5 percent of their equity. Banks/DFIs will require prior approval from SBP in order to purchase shares of a company in excess of 5 percent of their paid-up capital or 10 percent of the capital of the investee company, whichever is lower. Furthermore, aggregate investments of banks in shares should not exceed 20 percent of their equity. Any shares acquired in excess of 5% limit due to underwriting commitments must be off loaded within a period of three months.

(v) Banks/DFIs may also take exposure in future contracts to the extent of 10 percent of their equity on aggregate basis. In this connection, the 10 percent exposure limit for future contracts will include both positions taken in futures buying and selling.

To strengthen further risk management framework, SBP like other countries is steering the implementation of Basel-II in a phased manner. Initially banks are required to adopt the Standardized Approach for credit risk and the Basic Indicator/ Standardized Approach for operational risk from 1st January 2008. Subsequently, once they have improved their in house systems, they would have the option to switch over to more advanced approaches from 1st January 2010 subject to the adequacy of capacities and capabilities and its due diligence by SBP.

As a further step to strengthen governance of banks, they are required to undergo credit rating annually. The rating must be announced publicly and disclosed in the financial statements of the bank.

SBP also requires banks to appoint auditors from a panel of pre-approved auditors maintained by it. The objective is to ensure credibility of audited financial statements of banks.

In the area of monitoring and supervision, SBP has implemented a comprehensive framework, which is underpinned by regular on-site inspections of banks and DFIs under the regulatory ambit of SBP. Banks are inspected in accordance with a pre-approved annual inspection plan, following the CAMELS-S[1] approach. SBP has also developed a comprehensive surveillance mechanism – the Institutional Risk Assessment Framework (IRAF) – to capture the host of risks facing individual banks based on the information gathered from on-site inspections, off-site supervision, market intelligence and self-assessment by banks. The objective is to obtain a composite rating for each bank for effective and proactive supervision by SBP.

Finally, SBP is endeavoring to further strengthen its own governance processes in consultation with its Board of directors. An adequate and appropriate governance framework is crucial for the optimal functioning of any enterprise, but more so for a central bank because of its objectives of maintaining price stability and ensuring financial stability along with its crucial contribution to the overall economic policy framework. Furthermore, a vibrant and effective regulator is able to carry forward the corporate governance reform process more rigorously.

SBP is fully cognizant of the need to implement good governance practices in its own functioning and has empowered its Board of directors to provide oversight and direction of affairs and business of SBP. In order to modernize SBP's operational strategies and strengthen its governance, the organization has been successfully restructured in 2006, followed by adoption of market-driven compensation packages for its employees in 2007. The focus of the SBP management has been on improving risk management and internal

[1] CAMELS-S covers capital adequacy, asset quality, management, earnings, liquidity and sensitivity in addition to systems and controls of banks.

controls systems within the organization as well as enhancing transparency in its communications on policy and financial sector issues. SBP is also working towards developing adequate policy framework for consumer protection and has set up a Consumer Protection Department to safeguard consumer interests.

Impact of corporate governance reforms

Pursuant to multiple reforms initiated for the purpose, there has been a visible improvement in the corporate governance practices of banks. The fundamental change is in the effectiveness of the board. The implementation of Fit and Proper criteria has ensured that board members are well equipped to carry out their responsibilities. The criteria is also a measure to exclude unscrupulous individuals from the highly responsible position of a board member, In terms of performance, the Boards of directors now meet more frequently, focusing largely on strategic objectives and management oversight. The scope of the Board's policy making function has enhanced to cover a broad range of areas, such as systems and control, risk management, human resources, credit, investments, etc.

Professional management is appointed to carry on the banks' operations. Furthermore, internal control system has been strengthened in banks through setting up of audit committees and internal audit functions. Compliance officers are now appointed to manage banks' compliance to the policy framework and laws and regulations, including the AML requirements.

The frequency of financial reporting has improved through circulation of quarterly accounts. Financial reporting standards are at par with international best practices while credibility of financial information has received a boost through rotation of auditors after every five years. Enhanced disclosure has positive implications which go beyond just accounting statements of the banking entity. It is a mechanism for the market to assess the quality of assets, and earnings, and expose any hidden risk, for example those arising from associates, subsidiaries, related parties lending etc.

These improvements have been reflected in international assessments of corporate governance framework in Pakistan. The ROSC-CG assessment of Pakistan in June 2005 acknowledges that "Reform to improve corporate governance has been significant, including the introduction of a Code of Corporate Governance and increased vigilance by regulators." The ROSC-CG assessment further notes that "The SBP has also been instrumental in improving corporate governance in the banking system, by requiring banks and DFIs to adopt the Code, and by assessing compliance with other relevant aspects of prudential regulation specifically applicable to banks/DFIs." Similarly the World Bank's 2007 report on Doing Business in South Asia recognizes that "Pakistan provides relatively strong protections for minority shareholders against the misuse of corporate assets". It ranks 19th worldwide on protecting investors.

Outstanding corporate governance reform agenda

While considerable progress has been achieved in enhancing corporate governance practices of banks, SBP is geared towards filling in the remaining gaps.

In this regard, foremost is the need to develop a suitable cadre of professional directors who are knowledgeable of banks' affairs as well as independent of their management and majority shareholders. Allied to this is the need to clarify and strengthen directors' fiduciary duties to act in the interests of the bank and all of its stakeholders. It is also essential for banks to provide sufficient time and information to directors to prepare for Board meetings, structure Board meetings so as to allow ample time for discussion and establish appropriate criteria for assessing and improving performance of directors, including independent directors. To raise awareness on these and related aspects, SBP is working towards issuing comprehensive corporate governance guidelines for banks.

As earlier discussed, Pakistan's corporate and financial sectors present corporate governance issues peculiar to complex ownership and group structures. By conducting operations through a complex network of subsidiaries, controlling shareholders often acquire control of operations and/or cash flows disproportionate to their equity stake in individual companies. The key issues that arise as a result include: (i) inequitable treatment of stakeholders; (ii) dominance of controlling shareholder-directors over Board proceedings; (iii) lack of independence of the Board from the management; and (iv) channeling of bank resources to the benefit of group concerns.

In order to address such corporate governance issues, there is a need for group supervision by the regulators. As regard the banking supervision, SBP is working towards introduction of consolidated supervision whereby it will not be monitoring banks as a stand-alone entity but rather as part of the entire banking group. This will help to evaluate the strength of the entire group and to mitigate risks arising from group companies. A significant component of consolidated supervision will be review of group structures and detailed examination of related party transactions.

I would also like to share with you that SBP has recently launched a survey of banks to assess their corporate governance practices. The survey will help to identify areas for reform in the regulatory framework as well as its implementation by banks. The survey results will be a key input in further improving the corporate governance framework for banks.

Conclusion

Good corporate governance is essential in establishing an attractive investment climate characterized by competitive companies and efficient financial markets. It is imperative that Pakistan's banking sector develops and implements good governance practices, in order to provide impetus to economic growth. In the realm of a rapidly globalizing world – characterized by liberalization of markets, relatively free-er trade, sophistication of financial products and instruments, and growing awareness among consumers – Pakistan is ripe with lucrative opportunities for foreign and local investors alike.

I would also like to mention that no amount of regulatory intervention can fully institutionalize corporate governance unless Boards and senior management of banks appreciate the value addition of corporate governance to their productivity and competitiveness. In this context, banks should strive to build a reputation for honest and fair dealing while interacting with their internal as well as external stakeholders. Ethics, transparency and the competition for reputation, which are the cornerstone of good corporate governance, would invariably be the distinguishing features of banks that emerge ahead in an increasingly competitive market.