

Ajith Nivard Cabraal: Responsibilities of financial institution directors in the current turmoil

Address by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the Seminar on Regulation, Governance and Legal Responsibilities of Directors of the Registered Finance Companies, Colombo, 24 April 2008.

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Deputy Governors, Assistant Governors, Directors of Finance Companies, My dear friends,

I welcome you warmly to this seminar organized by the Department of Supervision of Non-Bank Financial Institutions. I also want to say “thank you” to all of you for taking the time to participate at this important occasion.

You may have wondered as to why the Central Bank has decided to have a seminar of this nature and invited you to spend nearly half a day with us. Therefore, at the outset, I will try to give you a little insight into the financial turmoil that the world is facing today. Many of you, I am sure, are aware of the upheaval that is taking place worldwide, and I am also sure many of you understand the risks that are associated with it.

My dear friends, somewhere around July-August of last year, various changes took place in the financial world. It started softly, like all difficulties, like all problems, and then suddenly, we realized that it was gathering momentum. The expression “sub-prime issue” was first of all, whispered; people didn't say it out loud; many didn't even know what it is. However, they soon realized that there was a serious issue that was brewing; some danger lurking. Then, gradually people realized that a major calamity was taking place in the financial markets of the world.

The crisis gathered momentum and then people also realized that the problem was highly complex; little by little, the major triple A rated banks also started to feel the impact. Banks realized that they have to change positions, and they started doing that. Some of the biggest banks in the world, who were highly rated for many many years, and held in esteem all over the world as being institutions that could never be in danger, began to feel the pinch.

Then, we heard about the European Central Bank, the Federal Reserve and the Bank of England pumping money into the mortgage markets in order to save the markets. We also heard about Northern Rock. The Bank of England had to put in well over 30 billion pounds, that is, more than double the GDP of Sri Lanka, just to save this one institution. The rescue even led to the nationalisation of the Northern Rock Bank: an outcome unthinkable just a few months ago! Then came Bear Stearns, and the writedowns of the major banks. The Bear Stearns share, which was trading at well over US\$ 100/- per share just a week before the event, was to be given to JP Morgans at \$2. At the same time, the Federal Reserve was to pump many more billions of dollars to prop up the Bank. Now they have negotiated the price per share up to \$10, or so I believe, but yet an amazing debacle! Then, there was also the case of Société Générale, which, although some what unconnected to the sub-prime issue, showed what may be happening underneath a calm exterior.

While all this was happening the risk of the US economy going into recession was increasingly becoming very real. So, the US Government and the Federal Reserve Bank have to come up with what is now hailed as a “Policy Stimulus Package”, (which actually is what we, in our part of the world may quite naively and innocently call a “Hand-out”), in order to deal with the situation. The US Government generous hand-out was going to be to the tune of a massive 160 billion dollars, more than 5 times the GDP of Sri Lanka! So, this is the type of turmoil that the world is in today.

We, in Sri Lanka, cannot think that we are well isolated from all these problems and that these happenings will not affect us. We cannot think that the deadly virus will not catch up

with us and infect us as well. It is therefore time for us to reflect on these situations and try to be a step ahead. That is what saves financial markets – being a step ahead!

I remember in February 2007, our Central Bank introduced an additional 1% provision for all performing loans of banks, because we realized that there was bubble that was forming. But, the public and media reaction to that policy action was somewhat rough. The next day's newspaper headlines said that Cabraal has delivered a kidney punch to the banks; some claimed that we were killing the industry; others lamented that we are making it difficult for the banks unnecessarily. Today, one year and 2 months later, people realize that our anticipation has saved the day. We don't want everyone to get up and shout and acknowledge it. But perhaps those of you who are directors of finance companies, as persons who are responsible for about 5% of the financial system of this country, would now realize that, there are certain steps that need to be taken early in order to safeguard the entire industry.

Sometimes, some people tell us, "our shareholders have been the ones who have made us. Our depositors have been continuously supported us. Therefore, we are responsible to our shareholders and depositors, and nobody else". Perhaps, there is some truth in that statement. But, think about this a little more deeply. What would happen if one finance company fails? Do you think your depositors are going to have the same confidence in you, even if it is somebody else that has failed? Do you think they are going to say, "it's okay. Only one finance company has failed. The company that we have deposited our money in is okay. Therefore, we can go on without any problem". Do you remember the finance company crisis in the late 1980s and early 1990s? When one finance company failed, what happened? Why is it that Northern Rock had to be supported so strongly by the Bank of England, even though it is not a clearing bank? Isn't it simply because the Bank of England realized that if one major bank fails, the domino effect, or the contagion effect will take place? So, my dear friends, it must be now clear to you, that as directors, you are not only responsible to your shareholders; you are not only responsible to your own depositors; you are also indirectly responsible to all depositors. Don't forget that if one fails, the resulting effect on the industry and the markets is going to be very very serious. Nobody is going to be spared. That's why we want you all to understand your responsibilities. That's why we take the necessary steps to regulate the industry so diligently. We have a responsibility, to preserve the financial system stability of this country. We take that responsibility seriously. We realize that if one finance company were to have difficulties, that it can have harmful effects on the others as well. That is why we issue directions and circulars. That is why we have teams who are well trained to supervise, monitor and regulate. We want to be regulators who will be able to understand you, and work with you in order to preserve the financial system stability of this country.

Occasionally, we place advertisements in the newspapers saying that such and such banks, finance companies and leasing companies are regulated by the Central Bank. Do you know that immediately after our advertisements, we get many calls? The callers say, "we have deposited our money in such and such institution. But, we don't see its name in your list. Is that institute regulated?" When we say that such organization is not regulated, many get frightened. So you see, people take regulation seriously. People believe that if something is regulated, then there is some element of order that is brought into that system. We are well aware of this and therefore we take a lot of pains to fulfil the regulating task. We have a Deputy Governor in-charge who looks into all these aspects. We have the Department of Supervision of Non-Bank Financial Institutions that supervises finance companies. They take their jobs seriously. That is why they are organizing a seminar of this nature.

Today, the business world is continuously looking at risk and trying to figure out how to manage risk and hedge against risk. Sometimes, unfortunately, some directors of finance companies think that they are immune from this risk. Some of them say: "we have a highly respected chairman; we have a super CEO. We have entrusted the entire management to those wonderful persons; they are very good; they are well known; they know their subject;

so therefore we can take it easy and relax.” That appears to be their philosophy. If you think so, you may do that. But remember, you would be doing that at your own risk! You must realize that you are also fully responsible. It is the collective board that will be held accountable.

Recently, you may have recently seen some advertisements that were placed by the Failed Finance Companies Commission, summoning all the directors, in the course of their inquiry. They have not said, “we will summon only the chairmen and CEOs of the failed finance companies”. No. They have summoned all. That is perfectly correct because every Director is responsible. So, each one of you too, will be responsible in the future with regard to your Company. That is why we have invited eminent professionals to come and explain to you, your duties and responsibilities. Sometimes, directors may not really appreciate their responsibilities and they may be quite comfortable about leaving key decisions to their colleagues, whom they trust implicitly. Maybe, you may comfortably place your trust in them, and indeed you may think you are entitled to do so, because you are working together. Nevertheless, when you take up a position as a board member, you also have a responsibility to discharge your responsibility in a very professional and systematic manner.

My dear friends, it is necessary for everyone to exercise a certain financial discipline within the organization. If the top people are lax, or if the board members do not ask the questions that need to be asked, then the tendency is for financial discipline to erode within the company. My dear Chairmen and CEOs, don't be frightened of, or upset with, the people who ask tough questions at Board Meetings. My dear Directors, don't feel over-awed or shy to ask the tough questions at Board meetings. You must do that. We want you, as Directors, to do that because it is not possible for the Department of Supervision of Non-Bank Financial Institutions to be doing all the questioning from the Chairmen & CEOs. We are performing a regulatory function. We will see whether the overall framework is in place. We will want to see whether your overall risk assessment positioning is acceptable. But, the actual running of the business is your responsibility. You have to ask the tough questions. You have to ensure that sound internal controls are in place. You have to look at the future plans to ascertain whether you are on the right track.

Often, I have seen eminent and respectable people accepting board positions, but not getting involved in the governance of the company. That is not good enough, especially in finance companies. Remember that your personal liability, will also be at stake in case of failure and such loss can be quite substantial if you have not taken the right steps. So, take the interest; take the time to study, and, be diligent in your activities. Actually, if you do that, you will find that it is much better for your Company, much safer for yourself, much easier for the regulator, and much easier for the market.

My dear friends, risk can be a sudden occurrence. Risk can, at the same time, be slow in coming. You don't know which risk is there, but you have to be alive to risk. Today, management is all about risk management. What are the risks in doing something? What will be the repercussions? What will be the dangers? You have to think-safety first, just like how it is said at some of the modern construction sites. When you go to some construction sites, you see a large sign that says “safety first”. Why? Because you have to survive before you are able to construct, and accidents can be both painful and costly. In looking at safety, in the case of financial institutions, the important factor is to focus on liquidity management. You may be profitable. You may be having a very good plan for the future. But if you do not have liquidity, i.e., if you do not have cash to meet your obligations, you cannot survive. It is like a very fit athlete who can run very fast. But, if the athlete cannot breathe for some reason, he will soon be dead notwithstanding his fitness. Your liquidity, or your cash inflows and cash outflows is also like breathing in and out. These cash flows have to be monitored very carefully. Liquidity management has to be practised diligently. The board members of finance companies must also learn and appreciate the principle of liquidity management. Don't think that it can only be left to the executives of the company. In the final analysis, the executives may not even be responsible in a legal sense. The legal responsibility will rest with you!

I am sure the other speakers will expand on all these aspects that I touched upon. So, I will now conclude with a few overall thoughts.

My dear friends, take your responsibilities as Directors very seriously. Keep abreast of what is happening. Keep abreast of the markets. Keep abreast of the risks that are taking place, both globally and locally. Watch the world and environment carefully. Be alive to new techniques. Take the interest to do all that, because if you do, then we can all have a healthy market. That is what we at the Central Bank, are hoping you would discharge your responsibilities diligently. The last thing we would like to do is to call you up and to say that your business is not run properly. We don't want to do that. But, at the same time, in the interest of the entire system, there may be occasions that we have to do that. So, please understand the rationale for our regulation. We are responsible for financial system stability and you, in an indirect way, are also responsible for that.