

## **Amando M Tetangco, Jr: Corporate governance reform in the Philippines – progress and challenges**

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Asian Roundtable on Corporate Governance, Manila, 9 September 2009.

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This roundtable conference on corporate governance is indeed timely as the world now moves to redefine the global corporate, financial and regulatory architecture with the view to prevent the recurrence of a similar crisis in the near or distant future.

Many have concluded that this crisis was to an important extent the result of poor adherence to the core tenets of good governance. Decisions overstepped the principles of good governance either due to excessive risk-taking, conflicts of interest and or opacity of transactions.

In the BSP, we take governance of banks seriously because we know banks are key in keeping the economy well functioning and growing. One of the main reasons our economy has weathered the crisis relatively better than most in our region is that our financial system has continued to function normally even at the height of the crisis in the last quarter of 2008.

In this regard, please allow me to walk you through BSP's initiatives to strengthen good governance in the financial industry and our continuing efforts to ensure that good governance principles are woven into the organizational culture and operations of our supervised institutions.

### **BSP initiatives on corporate governance**

#### ***Setting the tone from the top***

At the BSP, we believe that the corporate governance principles of Fairness, Accountability and Transparency should complement our banking reform advocacies. When we were trying to flesh out the implementation of these tenets to banks, we asked ourselves where better to set the tone of good governance than at the corporate top? Indeed we wanted to ensure that only those deemed “fit and proper” for the jobs are confirmed to assume their posts. To accomplish this, we issued regulations that set out standards on the qualifications of directors and key officers of financial institutions, putting as much weight on competence as on integrity. The BSP likewise required the members of the board to attend a seminar on corporate governance to formally structure the learning on the ethos of good governance. For this undertaking, the BSP accredited seven (7) training providers, which include the Institute of Corporate Directors.

We have also made explicit our expectations from the board of directors of our supervised financial institutions. We have issued regulations clearly identifying the duties and responsibilities that the board itself and the members of the board, in their individual capacity, should carry-out. Responsibilities of the board that have been established include the selection of officers and personnel to the adoption and implementation of adequate risk management policies. Also, consistent with the General Banking Law, the BSP has required that banks have at least two independent directors on their boards. In addition, we have prescribed that risk management, corporate governance and audit committees be created in the board.

All these may be considered as parts of an internal line of defense against excessive risk taking or attempts to cut corners that may result in unsafe and unsound practices.

### ***Enhancing transparency, disclosure and financial reporting***

Our campaign for good corporate governance didn't only cover determining "fit and proper" officials, but also included equipping the officials with the necessary tools for making informed decisions and for relaying the same to stakeholders. In this respect, the BSP adopted the International Accounting Standards. This aligns our financial reporting principles with the global standards and substantially improves the amount and quality of information disclosed by financial institutions to the public, beyond published audited financial statements and annual reports.

Along the line of promoting transparency and disclosure in financial reporting, we have established an accreditation process for external auditors. This raises the bar for adherence to control standards and ensures that financial institutions will be audited only by external auditors who adhere to such quality control standards. I am pleased to report that to further cement this move, the BSP signed (just last month) together with the Securities and Exchange Commission (SEC), the Insurance Commission (IC) and the Board of Accountancy a Memorandum of Agreement (MOA) to provide a working framework to harmonize the different accreditation processes of the regulatory agencies and allow mutual recognition of external auditors that they have individually accredited for certain types of institutions.

### ***Enhancing supervisory tools***

Many of us may have heard that this crisis was brought about by individual actions that have necessitated correction by collective action. Market participants have been seen to manage their risks effectively up to the point where the cost of doing so makes sense from their own point of view only. This presents a challenge to regulators. To avoid stifling appropriate credit activities and risk taking, the regulator must find the suitable balance when crafting banking regulation and enforcing supervision. The regulator must ensure that risks are well understood and appreciated by all concerned economic agents. In addition, the appropriate incentive structures must be present so that market discipline operates effectively in the future. The BSP, as an overseer of good governance in the financial system, therefore recognizes the need to constantly enhance its supervisory tools if it is to effectively perform this balancing act.

A step towards this goal is the issuance of the guidelines on Pillar 2 of the Basel 2 capital adequacy framework or the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review Process (SRP). This would give the BSP a better handle on how well the board of directors and senior officers understand their own risk management systems and capital allocation policies, as the ICAAP is bank-determined and should provide rules for implementing the bank's risk appetite.

In sum, the BSP has created an environment of good governance among banks by 1) setting the tone of governance from the top by choosing only fit and proper directors; 2) equipping the board of directors to make smart risk decisions through appropriate information and disclosure tools; and 3) allowing bank management to implement those risk decisions in a framework that protects the stakeholders.

By creating this environment, we hope that banks would move from "mere compliance, to performance".

### **Corporate governance scorecard for banks**

Before I conclude my remarks this morning, allow me to share with you the issuance by the BSP of the Corporate Governance Scorecard (CGS) for Banks. I am quite pleased to mention this, as I have been told this is the first of its kind in the world. The CGS for banks initially covers universal and commercial banks and their subsidiary and affiliate banks. It

was made possible through our partnership with the ICD and representatives from the banking industry.

The CGS for banks was broadly patterned after the scorecard for publicly listed companies, which was customized and refined to make it suitable for banks. In addition to the five (5) corporate governance categories that we have adopted from the Organization for Economic Cooperation and Development (OECD), the CGS for banks includes a category on Control Environment and Processes in recognition of the importance of risk management in banks. The 20 U/KBs involved in this project were asked to rate themselves using the questionnaire issued by the BSP. The “person-on-the-street” approach was adopted in evaluating the corporate governance practices of the concerned banks. This takes on the perspective of a depositor or investor that has no other access to information aside from those available to the public, including those posted in banks’ website.

Based on the evaluation of the submitted CGS of U/KBs, the industry charted a high average score of 84%. Although this did not come as a surprise, we are nevertheless pleased as we take this as an indication that the banking industry is indeed embracing the principles of good governance. I would also like to share with you, that among the six (6) corporate governance categories, the U/KBs registered the highest score in Control Environment and Processes at 89%. The top three (3) U/KBs had an average score of 94% while the bottom three had an average score of 66%, or a margin of 28%. However, if we look at the average scores of the top three (3) and bottom three (3) on a per group basis the margin narrowed down to 15% as the top three (3) of the thirteen (13) universal banks received an average score of 94%. The same margin was maintained for the seven (7) commercial banks, as their top three (3) posted an average score of 85%.

The BSP intends to continue the CGS for banks on a yearly basis and eventually expand its coverage so as to include all types of banks under our supervision. We believe that this endeavor will take us a step closer to strengthened investor confidence and capital market development.

### **Roadmap for the future**

Moving forward, the BSP will continue to maintain its stance of being a step ahead in initiating reforms for good governance in the financial industry. For example, we recently conducted a study on whether we should impose a limit on the number of institutions wherein an individual may serve as an independent director. Based on our assessment, there is no immediate need to change existing regulations, we will, however, monitor any development in the industry that may indicate an abuse of the existing regulatory leeway. Also, we are proposing an amendment to the BSP Charter that would require our prior approval for the transfer of substantial equity holdings in banks. We believe that this additional measure would help in ensuring that only those with indubitable integrity, capacity and competence would have a stake in the banking industry.

The BSP has also started planting the seeds for increased financial literacy in the country as we believe that the financial sector and ultimately the Philippine economy will benefit from increased public awareness. This will strengthen the confidence of the market in the financial system and at the same time, foster a more transparent way of doing business. The BSP created a group dedicated solely to advancing financial literacy and we have also tied-up with the Department of Education to include in the curriculum of grade school students basic topics on savings and money management.

### **Concluding remarks**

To conclude, governance is a reflection of the values of individuals within an institution. The initiatives we have started to promote good governance are only as good as the people

observing them. This is similar to the art of making ceramics. Different potters shaping the clay will come out with different interpretations of the same pattern, although each one of them followed the same process and used the same tools. The challenge for us, in this case, is to ensure that the potters have the skills, the right values and perspective in shaping the delicate piece of art.

Thank you and good day.