Rasheed Mohammed Al-Maraj: Corporate governance lessons to be learned from the global financial crisis

Keynote address by HE Rasheed Mohammed Al-Maraj, Governor of the Central Bank of Bahrain, at the Gulf Cooperation Countries (GCC) Board of Directors Institute – Senior Director Workshop, Manama, 2 November 2010.

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Your Excellencies, Distinguished Guests,

Ladies and Gentlemen:

It gives me great pleasure to be with you here this evening and to have the opportunity of addressing such a distinguished audience. The events of recent years have certainly pushed the issue of corporate governance to the top of the agenda, both for business leaders and for regulators. It is an indication of the importance that is attached to this subject that so many of you have found the time in your busy schedules to participate in this workshop.

It will probably not surprise you that my theme this evening will be the lessons that can be learned from the global financial crisis for corporate governance. I plan to talk about what lessons the financial crisis has for banks and the extent to which these might also be applied to firms and businesses in other industries and sectors.

Unfortunately, the global financial crisis has provided many illustrations of failures of corporate governance. There is a common pattern in the financial institutions that have failed since the summer of 2007. The Chief Executive was a dominant figure who made sure that he alone took all important decisions. There was no culture of open debate and discussion among senior management, with the result that other members of the board of directors did not feel able to challenge the Chief Executive's decisions. Many bank boards lacked banking experts. Individuals were recruited to the board of banks for their connections rather than for their knowledge of the banking industry and their ability to ask the right questions.

I am sure you will agree that these practices are undesirable in any type of corporation. Any business that is run this way is unlikely to succeed. But because of the special position of trust that banks hold, these failures have affected far more people than just their shareholders, creditors or employees.

The Basel Committee on Banking Supervision, an international grouping of bank regulators drawn from the G20 countries, has recently revised its detailed guidance on the corporate governance of banks in the light of the crisis. In October it issued a set of 14 Principles for Enhancing Corporate Governance in Banks that up-dates its earlier guidance on this subject. Many of the Principles set out by the Basel Committee seem to me to be of general application to all firms, and not just the banks. So I thought it would be helpful to discuss the relevance of a few of them.

First of all, with respect to board practices, the Basel Committee states that the board has overall responsibility for a bank, including its business and risk strategy and financial soundness in governance. This might appear to be a statement of the obvious, but it is worth thinking about what this implies for boards of directors.

Perhaps the most important consequence, as the Basel Committee states, is that the board must pay attention to the long-term interests of the institution and to those of all stake-holders, including depositors and creditors. In other words, good corporate governance means not focusing on short-term returns to shareholders, but concentrating on what is in the best long-term interests of the company. This will often involve taking into account not only the interests of the owners, but also the interests of creditors, employees, and other stake-holders. It requires to the board to take a broadly balanced view of its responsibilities and to think of the long-term and not just of the next quarter's results.

The Basel Committee also recommends that there should be a clear distinction between the responsibilities of the board and those of senior management. While the board takes overall responsibility for the direction of the business, the senior management should ensure that a bank's activities are consistent with the business strategy, risk appetite and policies approved by the board. An especially important responsibility of senior management is to ensure that there are appropriate systems for managing risk, including a comprehensive and independent risk management function.

The importance of an independent risk management function is something clearly underlined by the financial crisis. Prior to the crisis, some banks did not give the risk management function the stature and authority that it needs. Rather than being treated as an integral part of the business, risk management and compliance were seen as overhead costs which were a distraction from profit generation. Risk managers lacked the direct access to the board which would have given them the ability to challenge the Chief Executive and other senior managers. Accordingly, the Basel Committee recommends that banks should appoint a Chief Risk Officer who should be a senior executive with independence and authority who is in overall charge of a bank's risk management functions.

This Principle is also of general relevance to other types of businesses. Think, for example, of the experience of BP during the Gulf of Mexico oil spill earlier this year. Subsequent investigations into the company have shown that risk management, and planning for contingencies such as a major oil spill, did not carry a high priority with the BP senior management who regarded it as an unnecessary overhead expense. The result was the near collapse of the company after suffering billions of dollars in losses, which a stronger risk management framework might have helped to prevent.

The third, and final issue which I would like to discuss this evening concerns compensation practices. As I am sure you are aware, a major contributory factor to the financial crisis was that the staff of financial institutions were rewarded for short-term risk-taking. The incentive structures created by bonuses paid over a limited time horizon encouraged traders to focus on short-term profitability and financial engineers to design new financial instruments that could generate immediate profits, while the risks were pushed off to some indefinite future date.

In its Principles the Basel Committee recommends that the board should review the design and operation of the compensation system and monitor it to ensure that it operates as intended. Compensation should be effectively aligned with prudent risk-taking, including the time horizon over which risks materialize and should also be symmetric with risk outcomes. This last statement means that compensation practices should avoid paying out large bonuses on the basis of short-term profits, when there is a possibility that the transaction could result in significant losses to the firm in two or three years' time. Bonuses should, therefore, reflect the overall financial impact of a transaction, the results of which may not be known for several years.

As with the other Principles, this one is also of general relevance. All firms, and not just banks, need to avoid a situation in which their compensation practices reward employees for taking excessive short-term risks. This is not to say that bonus systems are undesirable. They clearly have a role to play in providing incentives to employees to perform well and reduce the fixed element in employee compensation, thus giving more flexibility in cost control. But remuneration systems need to balance risks and rewards.

The common theme through each of the issues I have talked about this evening is the importance of avoiding short-termism. The conclusion with which I would like to leave you this evening is that the greatest risk to a business arises from an exclusive focus on the short-term, whether it is the next quarter's results or an employee's end-of-year bonus. Successful businesses are those that plan for the long-term, that understand the risks of their industries and sectors, and which invest and build for the future. High standards of corporate governance are an essential mechanism to ensure this long-term perspective.

Thank you for your attention.