Zeti Akhtar Aziz: Enhancing corporate governance practices in the Malaysian financial sector

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the official launch of the Financial Institutions' Directors Education (FIDE) Forum, Sasana Kijang, Bank Negara Malaysia, Kuala Lumpur, 12 June 2012.

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It is my great pleasure to be here this morning at the launch of the Financial Institutions' Directors Education (FIDE) Forum. The establishment of this Forum, an initiative by the founding directors of the FIDE program will contribute to further the efforts to enhance corporate governance practices in the Malaysian financial sector. Many of you have made invaluable contributions to the conception and development of the FIDE program and its ongoing refinement. The program is not only unique and highly effective, but it is delivering palpable change and contributing to higher standards of corporate governance in our financial industry. This in turn is supporting stronger, and more resilient financial institutions.

Following the recent global financial crisis, corporate governance practices in the financial industry have come under significant scrutiny. There has been increased pressure on the management, boards of financial institutions and on regulators to significantly improve the governance practices in the financial industry notably on the incentive systems, accountability and controls. The problems that led to the build-up to this however, are not new. Issues around misaligned incentives and an over-emphasis on short term performance which encouraged reckless risk-taking, in addition to the lack of transparency, and the pervasive conflict of interests have long been the focus of public attention especially in relation to companies with dispersed shareholding structures. These same issues however, are far more serious when they involve the financial institutions given the significant externalities inflicted on society following the failure of such financial institutions. Banks in particular are especially vulnerable to the consequences of governance failures given the critical importance of public confidence to their very survival.

Since the crisis, substantial work on several fronts have been devoted to strengthening the resilience of financial institutions. New capital and liquidity standards have been a key focus of the global regulatory reforms and the work to transpose these global standards into national regulations are now well underway in many countries, including in Malaysia. While this will deliver significantly improved frameworks for risk-taking by financial institutions, they remain, at best, poor substitutes for good governance. Evidence of this can be drawn from the contrast between institutions that operated under the same regulatory framework, but that experienced very different outcomes during and after the crisis.

The comparisons are revealing. Of significance has been the observation – including in the most recent cases of massive bank losses – that behaviour and culture had a more significant part in the recent governance failures. Despite having independent directors and elaborate control structures in place, firms have failed because of decisions by their management and when boards have not effectively performed their oversight role. This has been principally attributed to the lack of sufficient collective knowledge of the board and inadequate competence of individual directors which in turn have led to poor judgements that hampered the ability of the board to rein in excesses at an early stage. Competency gaps generally allow for individuals on boards or from senior management to exert a dominant and undue influence over the decision making process, without being subject to sufficient scrutiny and effective challenge. This occurs when Boards are not able to grasp the risks associated with inordinately complex activities that their institutions are engaged in. This is generally further compounded by the failure to provide an effective countervailing influence to an overzealous risk-taking culture among front-liners who are principally driven by the pressure to deliver short term returns.

Of course, sound processes and structures will continue to have a central role in any good governance framework. This provides the parameters within which decisions can be made. However, the growing significance of behavioural, cultural and ethical issues suggests that governance frameworks must give greater attention to the "softer" aspects of governance. A clear reason for this is that the more challenging and fluid operating environment demands greater exercise of judgement by management. Behavioural, cultural and ethical norms, are likely as a consequence, to assume more importance in defining the boundaries within which management will make such judgements. As institutions become larger and more complex, boards themselves must also have the ability and confidence to assess the nature of the risks to the financial institution's strategic plan and business direction. This will entail behavioural and cultural changes within the boardroom that will involve changes to the board dynamics and the ability to effectively harness the collective knowledge and expertise of the board. It will involve the courage to break away from the status quos that promotes "group think" over diversity.

Developments in supervisory approaches will also reinforce this trend. The bar on corporate governance continues to be raised through more intensive supervision that focuses on board effectiveness. Supervisors are increasingly looking for evidence of a mix of technical and strategic competencies on the board that will support meaningful engagements both within the board, and between the board and management. Assessments are also made on whether boards function in a manner that promotes independence of judgement, and the extent to which boards are able to define the acceptable risk appetite for the institution and to oversee its translation into appropriate policies and behavioural norms.

Following the Asian financial crisis, strengthening the governance of financial institutions was a key priority which culminated in a number of regulatory reforms that established the framework of governance practices that exist today. In many respects, the financial sector in Malaysia has progressed ahead of current developments. A set of governance principles and rules were introduced in the early part of this recent decade. This included the parameters for sound practices with respect to risk-aligned compensations – an issue that has been a focus of the current global regulatory reforms. This was followed closely by the implementation of an improved risk-based supervisory approach which places board and senior management oversight at the centre of an effective control environment within financial institutions. A more rigorous process for assessing individuals nominated to assume the roles of director, chairman and chief executive of financial institutions have also been introduced. As part of the efforts to bring about behavioural and cultural changes to strengthen the governance practices in the financial industry, FIDE was developed and introduced in 2008.

We have been encouraged by the resulting improvements observed in governance and risk management practices among financial institutions in Malaysia. Our supervisory oversight has shown that directors have exercised a more active role in ensuring effective alignment and implementation of risk policies, business strategy and capital management. The quality of engagement between boards and management has also improved substantially in particular, on major strategic decisions and risk developments. Our supervisory engagements with boards have also benefited from the issues raised on areas of concern and material developments. There has also been increased efforts to strengthen the mix of skills, experience and expertise of the Board composition to improve the overall effectiveness of boards. This has resulted in more independent directors being appointed to the boards in most of the financial institutions.

The environment confronting financial institutions will continue to be immensely challenging, particularly in the coming years as global financial conditions remain highly volatile and uncertain, and as regulatory reforms start to take effect. In this environment, a number of areas will become more important to reinforce the effectiveness of boards and sound governance.

First, board-level engagements on risk issues will need to be strengthened further. This can only be achieved if boards have a sound understanding of the institution's business model, and a strong grasp of the changing complexion of risks in which the institution is exposed. Committed resources should therefore be available to the board to support their understanding of material developments affecting the institution, and to hone their judgement on matters concerning risk strategy. This should include relevant and meaningful management of information flows and risk analysis to the board, the ability to retain talent including external expertise where required, the ability to attract individuals with relevant competencies and experience to serve on boards, and the budget for board development and education.

Second, with the growing expansion of financial institutions in scale and complexity, there is a need to inject greater diversity into boards to enable the board collectively to deal with the broader range of issues across the institution's activities. This needs to be embedded within the framework for board renewal and succession. As institutions expand across borders, diversity can also enhance the board's appreciation of regional and global trends, and improve the ability of the board to provide strong leadership in response to cultural nuances and competitive dynamics in different markets. This will also be important for the effective oversight of group-wide risks and strategies.

Third, with increased expectations placed on boards, boards will need to have the means to objectively evaluate their own performance and examine ways in which board effectiveness can be improved. Overcoming cultural norms that impede more formal processes for open and honest engagement among peers remains a challenge. In the same way that a weak process for the evaluation of management performance would be a cause for concern, the same would hold true for the board. Guided self-evaluation frameworks are reinforced by an environment that encourages candour and openness, and supplemented by third-party independent reviews, have worked well for some of our institutions. More progress in these areas for maintaining high-performing boards rather than the more prescriptive approaches, which would most likely yield results that fall short of the desired outcomes.

Let me take this opportunity to discuss some of the key initiatives that are currently being pursued by the Bank in the area of governance of financial institutions. The Bank has made proposals in the new financial services legislation which will augment the general duties and responsibilities of the board under the Companies Act so as to provide emphasis to the specific key considerations in the responsibilities of boards of financial institutions. Boards would now need to have regard to the interests of depositors and policyholders, the long term viability of the institution and to have in place reasonable standards of fair dealings in the oversight of the implementation of the business and risk strategies of the institution. The statutory duties would also include an explicit duty to ensure and oversee the effective design and implementation of a sound control environment.

Work has also commenced to update and streamline the current regulatory guidelines on corporate governance for banks, insurers and takaful operators with a view to reduce the duplication across different standards and to sharpen the focus on the overall responsibility of the board for risk and control. Existing prescriptive rules would give way to broader principles of behaviour. The review will also better align the regulatory framework with the current supervisory approach. A thematic review of the remuneration practices in the financial sector is also planned to take into account how it might influence risk-taking behaviours.

Also in train is a review of the supervisory process for assessing the suitability of persons that can serve on boards of financial institutions. This review will leverage on the work by the FIDE Forum. Looking further ahead, the Financial Sector Blueprint sets out additional recommendations to further strengthen incentives and enablers for sound governance and risk management standards in anticipation of the growing complexities of our financial landscape.

Let me draw my remarks to a close. The task of providing stewardship, direction and oversight of financial institutions essentially falls squarely on the board. The responsibilities that go with this are great and I believe that we need the best directors in the financial industry – not just because of the importance of the financial sector to the broader economy, but because financial institutions, through their pervasive role in supporting economic activity, can be a powerful influence in raising the standards of corporate governance across corporate Malaysia. I expect that the FIDE Forum will have an instrumental role is realising this vision by professionalising the role of directors, and showing the way in the best governance practices. On our part, the Bank greatly welcomes this initiative which will facilitate new opportunities for greater engagement with directors in the financial sector as a collective body, on regulatory issues and developments. On that note, it is my great pleasure to officially launch the FIDE Forum. I wish it every success.