Muhammad bin Ibrahim: The challenges of corporate governance in the financial services sector

Keynote address by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the University Malaya's (in collaboration with the Asian Institute of Chartered Bankers and the International Centre for Education in Islamic Finance) Workshop on "The Challenges of Corporate Governance in the Financial Services Sector", Kuala Lumpur, 6 August 2014.

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It is my pleasure to be at this workshop on the theme of "Challenges of Corporate Governance in the Financial Sector". I would like to congratulate the University of Malaya, the Asian Institute of Chartered Bankers and the International Centre for Education in Islamic Finance for the joint effort to organise this event. I am also encouraged to see speakers from the world of academia, the financial industry and the public sector congregate to offer different perspectives on this important topic. My remarks today will touch on recent issues relating to corporate governance standards with particular emphasis on the financial sector.

The growing emphasis on good governance

The motivation for strengthening corporate governance in the financial sector is well-established. Unlike other industries, the financial sector plays an important intermediary role that relies heavily on public trust and confidence. Being highly visible entities, any lapse or failure in the governance of financial institutions, whether real or perceived, would attract adverse public reaction and could severely affect their reputation and public confidence. The failure of a systematically important financial institution may also result in serious ramifications and costs to the economy, given their roles and inter-linkages within a country's economy. For this reason, especially in the conduct its business operations, financial institutions are subjected to a higher standard of integrity and professionalism. In recognition of this, statutory responsibility is entrusted to the board and senior management to steer the institution and to safeguard its safety, integrity and reputation at all times. As public interest entities, actions by financial institutions have far reaching implications for a wide range of stakeholders.

Modernising corporate governance for the banking sector and the insurance industry has been a major focus for Bank Negara Malaysia following the Asian financial crisis in 1997. In the years since then, various regulatory reforms have been implemented to strengthen board practices, roles and responsibilities. These reforms include requiring the establishment of board committees, enhancing the independence of the board, expanding transparency and raising disclosure requirements. We also commissioned a study on board remuneration with the aim to improve board remuneration packages and as a way to retain and attract fresh board talent.

At the international level, more expanded efforts were undertaken to strengthen corporate governance in the financial sector in 2008 following the global financial crisis. It became evident that ineffective boards and weak senior management oversight had been key contributing factors to the failure of some of the largest global financial institutions. Conversely, institutions that performed better or were able to weather the crisis were those with a reputation for prudence, sound corporate governance and risk management practices.

At the international level, the Basel Committee on Banking Supervision updated its guidance on Principles for Enhancing Corporate Governance in 2010. This update followed the Committee's decision to revisit the 2006 guidelines in the wake of the financial crisis. The updated guidance reaffirmed the continued relevance and critical importance of the existing principles and highlighted the key areas which merit the most focus. These include the monitoring of risks on a firm-wide and individual entity basis. The guidance also emphasised the board's oversight of compensation structures. Earlier this year, the OECD launched a review of its Principles of Corporate Governance. The review, the first since the standards were updated in 2004, was commissioned to take into account developments that have taken place in the corporate sector and capital markets.

In Malaysia, the Securities Commission launched the Corporate Governance Blueprint in 2011 which outlined the strategic objectives for strengthening market discipline among capital market participants. One of the deliverables of the Blueprint was the publication of a revised Malaysian Code on Corporate Governance in 2012. A key feature of the Code is the emphasis on the role of directors and the need for a strong board composition.

Within the financial sector, the foundations for corporate governance have been further strengthened with the enactment of the Financial Services Act 2013 and Islamic Financial Services Act 2013. The functions and collective duties of boards of directors, and the fit and proper requirements for key responsible persons, are now clearly encoded in law. Boards of directors are now required by statute, when making decisions, to consider the interests of various stakeholders such as depositors, investment account holders, insurance policy owners and takaful participants. The new legislations also provide Bank Negara Malaysia with enhanced powers to take pre-emptive supervisory interventions against financial institutions to mitigate the risks of governance failures.

Following these changes in the law, existing corporate governance standards that are applicable to financial institutions are also being reviewed by Bank Negara Malaysia. The review would reflect the higher expectations demanded of the industry given the importance of the financial system to the economy. The review will elevate some of the existing industry "best practices" to become minimum standards for all financial institutions. Bank Negara Malaysia considers these enhancements as necessary, given the greater sophistication and higher level of maturity of the financial institutions and the financial system. We expect that the revised set of corporate governance standards would be issued for consultation by the end of the year.

The challenges and the imperatives

The governance of institutions remains a complex subject despite the many advancements that have been made over the years. This complexity stems from the highly dynamic and constantly evolving nature of the financial system. Financial institutions occupy a unique position in any economy. This uniqueness requires financial institutions to balance between growth, profitability and innovation, and the long-run stability of institutions. It is also this unique position that may create a moral hazard where financial institutions are incentivised to take excessive risks on the expectation that the cost of failure would be borne by a third party, for example through government bail outs or through the concept of "bail-in". This state of affairs, if not managed appropriately, would burden the taxpayers and increase the dissatisfaction of the general public with the industry.

The risks and trade-offs that I have mentioned would pose a number of specific issues and challenges for corporate governance.

Firstly, the complexity of the operations of financial institutions and financial groups is expected to continue to increase. Financial institutions are becoming larger and more complex as they grow in size and expand abroad. Earlier this year, the six domestic banking groups had overseas operations in 22 countries worldwide, including in all ASEAN member countries. The total overseas assets of the domestic banking groups had also increased by 15.4% from the previous year to RM362.1 billion. The oversight of financial groups with cross border operations is more complex and demanding, as groups have a highly diverse range of businesses, products and services, and diversified clientele bases. Managing people with different cultures will be an additional challenge. In some instances, the board and management will also have to deal with increased and sometimes conflicting regulatory and legal requirements across the different jurisdictions. For such financial groups, the lines of accountability and reporting must be clearly established to avoid the business becoming "too-big-to-manage". A more diverse board reflecting the financial group's cross border presence might also be necessary. As the operating environment becomes more complex, it is not an impossibility that sometime in the near future there would be a demand for "professional directors".

Secondly, financial innovation, including in the area of Islamic finance, will continue to expand as institutions seek their own competitive edge. While we should encourage such innovations within the bounds of prudence, the implication of financial innovations on governance arrangements and practices must be properly understood. For example, the introduction of new financing structures based on different Islamic contracts such as equity-based or risk-sharing concepts will likely demand different and more robust governance arrangements. In this context, the Bank is introducing Shariah and operational standards to promote greater legal and operational certainty and quality in Islamic finance transactions. These standards will set out, among others, clear duties and responsibilities of the various parties involved in Islamic contracts with the aim to ensure end-to-end Shariah compliance. At the same time, there will be enhanced disclosure requirements on risks associated with potential misconduct and negligence. In such circumstances, we expect the board to provide leadership, guidance and oversight in ensuring that the needs and rights of all parties are adequately and appropriately managed.

Thirdly, the implementation of global regulatory reforms will pose further challenges for the industry. While the reforms are well-intended, the complexity and impact of the reforms to business should not be underestimated. Increasingly, there seems to be a trend on the "extraterritorial" application of laws and regulatory requirements, which have implications on other jurisdictions. The extraterritorial effect of such laws may require changes to existing practices and may involve substantial costs in terms of system change and improving monitoring capabilities. At the board and senior management levels, an adequate understanding of the potential impact of these trends and regulatory changes is critical to help the organisation in setting business priorities while ensuring full compliance with emerging regulatory requirements.

With much at stake, board members must take seriously their responsibility to drive the corporate governance agenda forward. One important lesson we ought to learn is that weak governance causes the failure of financial institutions. The costs of salvaging a failed institution far outweigh the costs incurred to prevent such a failure. Over the long term, the failure of institutions would also cause businesses and households that depend on financial institutions for funding to be in a difficult position, erode public trust that would take many years to restore and consequently result in more intrusive and prescriptive regulation of the industry.

As stewards of financial institutions, boards and senior management bear the responsibility of ensuring that regulatory policies translate into operational practices. Rules must be embedded into the day-to-day business and operations that suit an institution's business environment. Good corporate governance will not emerge from mere compliance with regulatory checklists as each financial institution is different and unique. With careful introspection, each individual institution needs to continuously reflect on whether its governance arrangements, practices and business models are effective and still relevant. In doing so, each institution must continuously assess and take into consideration the nature, scope and scale of its business. In some instances, conventional and proven governance approaches might not work anymore and therefore new thinking and methodologies are required.

Real change cannot be dictated by regulation alone. This is neither sustainable nor possible. Instead, principles of good governance need to be deeply woven into the fabric – or DNA – of an organisation. Directors and senior management, as leaders of financial institutions, are in the position to foster a positive organisational culture. The board and senior management should work in harmony to cultivate an environment which appropriately balances between performance and stability. For instance, the structuring of remuneration schemes should reward long-term performance and encourage sound risk-taking. There should always be a balance between financial innovation and excessive risk-taking. While an equilibrium is not easy to attain, it cannot be achieved accidentally. But an equilibrium can be realised through careful design, taking into consideration an institution's internal structures and behavioural norms.

Needless to say, the accepted behaviour and values promoted and demonstrated by the senior leadership will influence the business culture and values throughout the organisation.

Talking about cultures and values, we should also be mindful about the need to educate and instil into the new generation of bankers the importance of integrity, ethics and professionalism. For this reason, industry training institutes like the recently established Asian Institute of Chartered Bankers play a vital role in cultivating higher standards of governance, ethics and professionalism in the financial sector. The importance of the contributions by these institutions cannot be underestimated. After all, graduates starting off their careers in the financial sector will be the leaders and captains of the industry in years to come.

Good governance ultimately depends on the existence of strong and competent boards and a pool of professional senior management. To remain effective, boards are often confronted with the challenge of achieving an optimal balance between the need for continuity and the need for fresh perspective. This brings into question the issue of board composition and membership, and how talent on boards should be continuously renewed. Because financial institutions are complex creatures, longer-serving individual directors can bring a depth of knowledge and experience into the business of the financial institutions, which would consequently strengthen the ability of the board to provide effective oversight. Such continuity also encourages a cohesive board. However, if not balanced appropriately, this can also lead to complacency and "groupthink", and as a result, the institution would remain stagnant and uncompetitive. Identifying and searching for new directors who are up to the task of governing complex financial institutions is not easy and takes time. It is due to these factors that the board needs to adopt a proactive and rigorous approach in the matter of board renewal and succession.

Balance also needs to be achieved in the incentive structures for financial institutions' board of directors. We are all aware that recent legal and regulatory developments in corporate governance have significantly raised the responsibilities and potential liabilities of board members. In order to attract and retain the right talent, it is essential to develop an appropriate remuneration package that is commensurate with the heavier and expanded responsibilities of directors. Similarly, financial institutions engaging in Islamic finance should also include a review on the remuneration of their Shariah committee members with the aim to attract and retain the best talents.

But having an attractive remuneration package as described above is not enough. Having a dedicated budget for the development and training of directors will also be crucial in helping them to acquire new knowledge and skills that enable board members to effectively discharge their duties and responsibilities. In a complex and fast changing environment, individual directors need to remain apprised of emerging trends within the industry and economy. Experiences accumulated over the years will no doubt help directors in discharging their roles and responsibilities. However, this will count for nothing if directors do not and cannot adapt to the dynamic nature of the banking and economic environments.

It is for this reason that Bank Negara Malaysia, in collaboration with Perbadanan Insurans Deposit Malaysia, introduced in 2008 the Financial Institutions' Directors Education Programme or better known as the FIDE programme. Since its inception, the FIDE Programme now offered under the ICLIF Centre for Governance and Leadership has provided customised training on corporate governance practices to more than 500 directors of financial institutions in Malaysia. This programme has had an important role in catalysing positive changes in how boards and senior management function and interact, thereby improving the overall quality of financial institutions' governance. It is also through this programme that a directors' network has emerged, enabling peer learning, and the sharing and exchange of experiences among financial institutions directors.

Role of stakeholders

In elevating the standards of corporate governance in the financial services industry, shareholders play an important role to engage boards and hold them to account. Demands for improvements in corporate governance could be driven by the institutional investors and minority shareholders. But for this to happen, they require relevant information on the financial institutions performance and operations.

In this context, the Bank has outlined proposals in the Financial Sector Blueprint to require periodic audits of corporate and Shariah governance to help investors better understand whether disclosed governance arrangements are reflected in actual practice. This will supplement the role of existing disclosure requirements which help investors assess the financial condition and risk profile of financial institutions.

Conclusion

It is my hope that as we venture into the future, this workshop will steer a dialogue towards developing a deeper understanding of the contemporary issues that confront the industry and yield new perspectives and insights around governance issues. Programmes such as this make an important contribution to that process.

On that note, I wish you a productive and engaging workshop.