# Bank of Uganda

**Remarks by**

**Prof. Emmanuel Tumusiime-Mutebile,**

**Governor, Bank of Uganda**

**At the**

**Breakfast Organised by the Institute of Corporate Governance  Uganda**

**Theme:** ***"Governance as a Core Pillar for Economic Development"***

**at**

**Sheraton Hotel.**

**November 25, 2016**

**Institute of Corporate Governance of Uganda: Corporate Governance Breakfast with the theme "*Governance as a core pillar for economic development*"**

President, Institute of Corporate Governance Uganda (ICGU)

The Executive of the ICGU Governing Council

Our Host, PWC

Ladies and Gentlemen,

Good morning

I would like to begin by thanking the Institute of Corporate Governance of Uganda for inviting the Governor to give a key note speech at this breakfast and to commend the institute for the excellent work that it is doing to promote good corporate governance in Uganda.

The theme of this breakfast is corporate governance as a core pillar for economic development. The link between corporate governance and economic development is probably not intuitively obvious so I will offer you my own perspective on how corporate governance can contribute to development.

A key driving force of sustainable development is the harnessing of positive externalities to private sector activities and the minimising of negative externalities. Positive externalities occur when social rates of return to investment exceed the purely private rates of return. Examples of positive externalities include the spillovers of benefits which occur when firms train workers, invest in research and development and adopt new technologies which generate "learning by doing' benefits. Examples of negative externalities include pollution or collusive or abusive manipulation of markets. Given that investable resources are scarce, long term development requires that social rates of return are high. Hence rapid economic development is more likely to be realised in a society which can enable the private sector to generate high private rates of return to investment while at the same time yielding positive externalities so that social rates of return are even higher. Conversely, economic development will be held back if private sector activities create negative externalities, thus depressing social rates of return to investment.

Why should corporate governance have any impact on positive or negative externalities of private investment? In any firm there is an inherent tension and potential conflict of interest between what are often termed the “insiders” of firms – dominant shareholders and senior managers – and the “outsiders” who include small shareholders, the creditors of the firm, its employees and customers and the general public. The insiders are those who have actual control over the form, but without effective restraints insiders may abuse their control over the firm to derive benefits for themselves at the expense of outsiders. Examples of this include:

- controlling shareholders might extract value from a firm at the expense of non controlling shareholders;
- managers may award themselves huge salaries or bonuses unjustified by their actual contribution to the success of the business, and;
- managers of a firm might evade paying its proper tax liabilities.

These actions are damaging not just because they transfer resources from outsiders to insiders of a firm, but also they create incentives for actions which are socially sub-optimal. For example, if minority shareholders fear that they will be cheated by controlling shareholders, they will not invest their money in a company and in a society in which the interests of minority shareholders are not protected, it will not be possible for firms to raise equity capital except through internally generated funds.

The essence of corporate governance is to ensure that the actions of a firms insiders – its managers and controlling shareholders – are consistent with the legitimate interests of all of its stakeholders, and do not benefit the insiders at the expense of outsiders. Corporate governance is not the only defence against abuse by insiders; there are also legal restraints, for example there are laws to prevent fraud and ensure minimum standards of health and safety in the workplace. But it is not realistic to expect the legal system alone to prevent all possible abuses by insiders; this would be very costly and cumbersome. Hence there is a need for standards of corporate governance which extend beyond the strictly legal obligations of a firm.

The banking industry presents unique challenges for corporate governance because the scope for conflicts of interest between insiders and outsiders is larger than in many other industries. The scope for conflicts of interest arises for several reasons. The balance sheets of financial institutions are opaque which makes it hard for outsiders such as depositors to evaluate their true financial condition. There are informational asymmetries with insiders having more accurate information than outsiders. Outsiders typically consist of atomised individuals which mean that they face “collective action” problems which impede their acting together in an optimal manner to defend their interests. As a consequence, the insiders of financial institutions have opportunities to exploit outsiders in a manner which creates negative externalities such as bank failures or even financial crises. For example, a bank may be managed in a reckless manner with any gains made as a result of taking excessive risks accruing to the owners and managers of the bank while any losses are borne by its depositors or taxpayers if they have to bail out the bank.

To mitigate the conflicts of interest in financial institutions and avoid negative externalities, governments impose prudential regulations, such as minimum capital adequacy requirements for banks, and mandate a public agency to supervise financial institutions and enforce the regulations. But we also recognise that statutory bank regulation and supervision by a public agency such as the Bank of Uganda cannot be expected, on its own, to guarantee the sound management of banks. Moreover, excessively heavy handed regulation, although it might protect depositors, can also stifle innovation and risk taking in banks, which would be detrimental to economic development. In a market economy, the onus for sound management, including the proper management of risks, must lie with the banks themselves. Bank regulators cannot be a substitute for bad bank managers. As such good corporate governance is an essential complement to good bank regulation and supervision.

The Financial Institutions Act, 2004, includes a framework for good corporate governance in financial institutions, which is supplemented by a set of corporate governance regulations which were issued by the BOU in 2005. Uganda's corporate governance regulations for financial institutions were influenced by the guidelines published by the Basel Committee on Banking Supervision, based at the Bank for International Settlements, which is responsible for formulating global standards for bank regulation and governance.

The corporate governance regulations for deposit taking financial institutions in Uganda focus on four key themes:

i) The fiduciary responsibilities of the Board of Directors;

ii) The importance of independent oversight of bank management;

iii) The priority which must be attached to risk management; and

iv) The need for independent audit functions.

These are also themes which receive emphasis in the King IV report, which I believe should be viewed as a complement to the corporate governance requirements which are already in place for the Ugandan financial sector. The King IV report also includes features which, although not specifically covered in our own corporate governance regulations because they fall outside the ambit of prudential concerns, are nevertheless relevant for financial institutions as well as non financial corporations; these include the importance of corporations establishing responsible and transparent tax policies and organisation wide remuneration policies. The King IV Report should help to strengthen standards of corporate governance both in the financial sector and in the non financial corporate sectors of our economy.

Thank you for listening.

Prof. Emmanuel Tumusiime Mutebile

**<u>GOVERNOR</u>**