Luís Máximo dos Santos: Corporate governance - importance and limits

Address by Mr Luís Máximo dos Santos, Vice-Governor of the Bank of Portugal, at the Conference "Corporate Governance - creating value for society", organized by the Portuguese Institute of Corporate Governance (IPCG), Lisbon, 25 October 2018.

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1. Allow me to begin by thanking you for the invitation to take part in this magnificent Conference alongside these distinguished the speakers and participants. I would like to congratulate the chairs of the board and general council, António Gomes Mota and Pedro Rebelo de Sousa respectively, representing the Portuguese Institute of Corporate Governance (IPCG) on the occasion of its 15th anniversary, for the organisation of this timely event, and warmly greet all the members of its corporate bodies.

The creation of this Institute 15 years ago was a moment of inspiration, anticipating – at a time when the subject was still relatively unspoken – the importance that corporate governance would assume.

Portugal needs strong private associations which encourage discussion on subjects of importance to the development of enterprises and the quality of management in its broadest sense, which are able to generate critical mass on complex themes, as is the case of corporate governance.

A special mention goes to the fulfilment this year of the objective to see approved a Corporate Governance Code, long pursued by the IPCG, and which is a landmark in private regulation in Portugal.

2. The theme of corporate governance has already been reflected upon at length, especially in the United States, where some authors traced the first uses of the term to the 1970s. In the United Kingdom, the so-called 1992 Cadbury Report is considered pioneering. It was produced by a committee set up to assess – even then – the underlying causes behind a number of corporate failures.

Since then, attention given to the theme of corporate governance – which has a multidisciplinary nature, bringing together knowledge of economics, finance, accounting, law, management and organisational behaviour – has not stopped growing. This growing interest is no stranger to the succession of corporate scandals with wide-reaching public repercussions, even before the financial crisis, as was the case of Barings Bank (1995), Enron (2002) and Parmalat (2003) – to name some of the most notorious – which in some way motivated the production of a set of corporate governance best practices by international organisations of note such as the OECD, World Bank and Basel Committee, amongst others.

But it was the financial crisis that began in 2007 and its tremendous consequences that brought the theme of corporate governance to the forefront of public policy, including in regulatory terms, in the most affected countries and the European Union.

Without analysing the causes of the crisis – which are numerous – it can be argued that it is widely accepted that one of the factors that caused and exacerbated it was the abject failure of the financial institutions' internal governance models.

The crisis occurring made clear everything that had been suggested by the theory: banking activity is so particular in comparison to non-financial corporations that it is essential to give it specific rules of governance.

The security of funds entrusted to the banks demands that they are managed in a sound and prudent way in order to preserve the confidence of depositors, customers and investors, thus maintaining financial stability. This is why the manner in which these institutions manage their business is crucial to guaranteeing a model of sustainable economic growth. Banks' management problems – and the isolated case of a single bank is enough – harbour high risks to financial stability that, should they materialise, can infect other banks and, in the last instance, seriously affect the financing of the economy, as the financial crisis well demonstrated. This therefore makes the theme of banks' internal governance very relevant.

3. Internal governance is the system of organising the duties, responsibilities, reporting and control lines in the financial institutions that support the management and business model.

The management and supervisory boards take on particular importance in the internal governance of financial institutions, as do the holders of essential roles that, inter alia, correspond to those responsible for the areas of risk management, compliance and internal audit.

This includes the following:

1. The decision-making process that allows the definition, at any time, of the way in which the interests of the banks' various stakeholders, internal and external, should be combined;
2. The definition of a strategy to promote the pursuit of these interests that do not always coincide; and
3. The concrete operationalisation of the strategy concerned.

The existence of a plurality of interests – of depositors, bond holders, customers, employees, shareholders and even managers themselves – inevitably mean there are conflicts.

A good system of corporate governance naturally means that the issues mentioned are resolved suitably: management of conflicts of interest and mitigation of information asymmetries. Allowing us to realise the importance of corporate governance: enabling the composition of diverse, potentially divergent interests and determining the actions of banks and the quality of their decision-making processes.

The internal governance model will therefore have a decisive role in banks' long-term sustainability. This decisive importance of corporate governance for banking activity has become, especially since the crisis, the focus of intense regulatory scrutiny.

4. The evolution of regulation has revealed an ever more granular trend, on a path that is not free from difficulties. In fact, the initial phase, in 2009 and 2010, revealed concern with one of the most salient aspects of the crisis – incentives misaligned with sustainable and prudent risk management. The practice of compensation schemes based on variable components indexed to fast expansion of trading volumes led to a culture of excessive risk. As a consequence, the initial reaction of international regulators was directed towards compensatory policies and practices.

From 2011, the regulatory agenda adopted a broader approach to corporate governance, becoming concerned with, at this stage, regulating corporate governance systems in banks, especially organisational and control aspects; and it is in the context of this wider regulatory vision that other aspects of governance start being regulated: internal audit, external audit and suitability of the banks' members of the management and supervisory bodies, as well as the holders of essential roles.

With the approval of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, generally known as "CRD IV", the standards on corporate governance started to be seen from a broad perspective, covering organisation, duties of control, people and compensation. Therefore an integrated vision of the organisational structure was adopted, of suitability of the people who manage and oversee the institution and those responsible for essential functions, of a solid and effective internal control framework, of the autonomous design of internal governance of risk and remuneration policies aligned with a sound and prudent risk culture.

Guaranteeing that the organisational structure of the corporate governance of the institutions is solid and the management and oversight are adequate became, naturally, a central concern for banking regulation.

From the outset, banks should define a profile for members of the management and supervisory boards and seek candidates that possess the knowledge, skills, experience, integrity and time necessary to fully carry out their duties.

Also indispensable is the presence of an adequate number of formally independent members of the management and supervisory bodies, in order to safeguard the interests of the various stakeholders suitably and preserve sound and prudent management, and ultimately, financial stability.

Banks must also fully comply with the rules relating to conflicts of interest (which differ from the rules relating to formal independence). As well as formal independence, "independence of mind" is also needed, a dimension that requires an absence of conflicts of interest, even potential conflicts.

The management function within banks cannot supersede internal supervision. On the contrary. Non-executive members of the management and supervisory bodies must be empowered to fully exercise their duties of diligence. They must scrutinise the day-to-day management, and respond to the interests of the banks' various internal and external stakeholders.

The internal supervisory function must in turn be provided with the information required for the complete fulfilment of its duties. It should be proactive in obtaining such information, and should exercise effectively its duties of assessing the internal control system, which is essential to ensure the reliability of the information provided during the decision-making process.

Banks should possess an internal organisation based on a clear distribution of responsibilities between their various units and functions, as well as clear vertical and functional reporting lines. Each employee must be fit for the duties they exercise, in accordance with a recruitment and training policy that conforms to the banks' specific needs.

In particular, banks should identify and assess the holders of essential positions, that is, those who exercise duties that confer significant influence on the management or whose duties can have a material impact on their risk profile.

The internal control mechanisms should have the empowerment, independence and capacity for intervention necessary to fulfil their objectives. The management and supervisory bodies should act in a way as to make clear the internal control functions contained in internal rules of procedure, and the assessment, career progression and compensation scheme of the staff employed in these areas must obey specific criteria, separated and distinct from the criteria followed for staff employed in commercial areas of the business.

Assessment and career progression policies and banks' remuneration policies and practices must line up with the interests of the members of the management and supervisory boards, as well as those of the employees in general as a goal of sound and prudent management.

The banks must possess a conflicts of interest policy that enable such conflicts to be identified and eliminated. And rules have also been defined to seek to ensure that the statutory auditor fulfils their mission with the required independence.

5. This is only a brief summary of the regulatory requirements imposed by European and national legislation in this area. Nevertheless, it is enough to recognise that the rules are manifold and demanding. However, events have demonstrated that these rules are indispensable when verifying the absence or ineffectiveness of self-imposed internal governance models.

With the financial crisis, it was politically inevitable, as a result of the understandable social pressure, that the theme of banks' internal governance moved from soft law to hard law.

Is the regulatory framework and the oversight of its compliance by the authorities enough to prevent behaviours similar to those that caused the financial crisis?

There is no doubt that this regulatory reinforcement, established and supervised uniformly at European Union level, enables us to say that we are much better provided for in terms of corporate governance requirements to ensure financial stability, which cannot go unmentioned.

But organisations are formed of people, and as such, the behavioural dimension has been recognised as essential for the effectiveness of a good internal governance model for banks and other enterprises. Even the best models may not resist the determination of anyone who might want to sabotage them. But the better they are, the more difficult it is to do so, hence the extreme importance of banks being provided with a robust governance model.

Without an institutional culture that is oriented towards compliance with rules and best practices, based on values that ensure a lasting reputation, and which are therefore a source of value for the enterprise, the objectives of public regulation may not necessarily be achieved.

In fact, institutional culture is an intangible concept but is decisive to the effectiveness of corporate governance.

Exemplary behaviour is developed in a social environment and becomes more difficult to obtain unless there is an inherent reward.

If society does not value the ethical character of behaviours, it is difficult to expect that an organisational culture emerges in enterprises which favours the effectiveness of good governance and best practice.

For that reason, ensuring the effectiveness of good corporate governance is not only a task for enterprises, regulators and supervisors; its effectiveness depends on our collective ability to create a society that duly values ethics.

Thank you very much for your attention.