CORPORATE GOVERNANCE AND THE BOARD ROOM

by
Joan de Zilva Moonesinghe

The twin peaks of banking and finance are confidence and integrity. One complements the other and the two cannot exist without each other. Confidence in a financial system is built primarily on its integrity – the slightest doubt about the integrity of a financial system can erode the confidence that supports it. In a bank-dominated financial system, bank regulators, with responsibility for market entry of licensed banks, are obligated to ensure the "fit and proper" attributes of bank management, from the Board of Directors to the senior anagement and key personnel of banks in whom the public can repose their confidence and trust. Thus regulators and the Banks, as the regulated, have a commonality of interest in what they aspire to – a safe and well-managed bank, functioning in an ethical and responsible manner, resulting in a robust and dependable financial system. From the number of corporate scandals that scan the not too distant horizon, it is evident that not everybody shares these aspirations.. There are the recent examples internationally: Enron, Parmalat, Worldcom and here at home, Pramuka, which brought to the fore, critical governance issues affecting the regulators and the regulated, equally alarmingly. Corporate Governance is therefore, the key word and reputation, just like values, which takes long to become firmly established, can be destroyed almost overnight, crashing with it, this confidence which is at the heart of the business of banking and finance. Why is confidence so important in banking? Money is the core of every capitalist economy and a coterie of well compensated people in the financial services industry become entrusted with the custody of the whole of a society's bank deposits, investments and in certain instances, even their gold. Thus what is profound here is that the corporate responsibility is one of trust – what is called fiduciary responsibility – where public deposits are placed in trust with bank management, so much so that the primary responsibility of bank management is to their depositors and not to their shareholders. Almost 80% of bank assets are financed by depositors' funds and less than 5% by equity, making banking business a highly leveraged business in the economies in which they function. In the case of the foreign banks, the challenge is whether they can ride the tide of economic growth now taking place in Asia. They should always ask themselves whether it makes economic sense to be wherever they choose to be. You might think the point is laboured in the opening paragraph to this note – but this fiduciary responsibility of bank management is at the heart of good corporate governance from the board rooms of banks to the ranks of top management.

Where there exists a gap between corporate governance in law and in practice, the importance of ethical behaviour becomes profound- especially in a business where conflicts of interest are inherent. The most important of these conflicts is the information and skills gap, between financial experts on the one hand and the less sophisticated depositors, borrowers and investors on the other. Integrity and impeccable behaviour thus become imperatives to handle these conflicts and to avert the Board room battles that may very well ensue as a result, which, in a banking institution may well destabilize the bank and have systemic consequences. Other more dangerous conflicts can arise if there is a divergence of personal and professional interests as a result of a lack of properly designed incentive remuneration programmes. This was evident in Enron where there was direct personal interest in some of the off-balance sheet structures. It is therefore imperative that the letter and, indeed, the spirit, of all prudential directions and regulations be observed wherever the banks operate. Banks, like any other corporate, are subject to the same human frailties; they make mistakes, can become too over-ambitious for market share and profitability. But they should own up, remedy their mistakes and learn from them. Most importantly, they must submit
themselves to regulatory interventions which are in their own interests. The trend towards rules-based governance may well lead to some banks assuming that everything, that is not prohibited explicitly, is permissible. Regulators naturally find themselves navigating in litigious seas. The guru of corporate governance, Sir Adrian Cadbury, states:

"Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to

encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align, as nearly as possible, the interests of individuals, corporations and society" (Sir Adrian Cadbury in 'Global Corporate Governance Forum', World Bank, 2000)

Directors of banks and financial institutions (FI) are said to carry a greater fiduciary responsibility than directors of other companies, and the public who repose their confidence in Bank management, would naturally tend to have higher expectations from Bank directors in their governance of these entities. The independence of directors must be assured at any cost as it is crucial that the public (depositors, borrowers, and participants in the economy) have complete confidence in the banking system and in the honesty and transparency of the banks' transactions. Establishing such trust and confidence is not possible until every bank/FI participating in the financial system, instills proper internal management and accountability structures, which are no less than the best possible standards. This should be the cornerstone upon which the corporate governance framework of the bank/FI is established.

This now takes one to greater eminence in the banking world on this subject. The former Governor of the Bank of England, Lord Edward George, Master of the Guild of International Bankers, in a recent address at the Guild's annual banquet, has been very frank regarding this situation, stating that " over the past few years we have seen some quite outrageous behaviour including attempts to get around legal and regulatory requirements……The natural consequence is to tighten the legal and regulatory framework to contain the distortions. Carried too far, there is the danger that the system as a whole could become over-constrained by such efforts to protect it from a relatively few rotten eggs." It is well known that the consequences of bad behaviour or market abuse are not just legal or regulatory penalties. The discipline of the market is a more stringent penalty leading to a loss of confidence and trust which will lead to an erosion of market share and which will undermine profitability. He aptly points out that the lack of professional integrity severely undermines the financial service sectors' effectiveness in delivering benefits to stakeholders, as well as to the entire society. He stresses that, although tightening the legal and regulatory framework and introducing strict penalties for those who violate such rules, could assist in curbing this trend, it is not sufficient. Rather, Lord George emphasizes, it is essential that professionals in the financial services sector maintain high standards of behavior and maintain their professional reputation. " Free markets in financial services just like anything else, cannot sensibly mean a "free for all". They need to be reasonably "fair" as well as reasonably "free" to serve their fundamental purpose."

The importance of Corporate Governance is well documented even in the Basle Committee's Core Principles for effective Bank Supervision, and on the basis of which a code of ethics for good corporate governance has been circulated to all banks. However, the practical reality is just something else. One has only to look at the information that is available in the public domain to see how it is practised. In certain cases, related party interests dominate and in certain instances, is the rule rather than the exception, albeit on an arms length basis. However, the limited or inadequate disclosures of these relationships deem them to be at "arms length" - but are they really? Directors of banks who have borrowing privileges with the banks they are directors on, serve no useful purpose. This is firmly espoused by the Basle Committee on Corporate Governance. They have borrowing responsibilities and not borrowing

privileges. In several jurisdictions, Directors on Bank Boards, are prohibited from having a borrowing relationship with the Bank they serve on and this is strongly advocated by the writer solely in the interests of the independence of directors and in the interests of the Banks they serve on. There is no reason why, if indeed a director's borrowing relationship is on an arm's length basis, this relationship cannot be established with a bank, he is not a director on. As it is now, credit officers in banks are known to feel intimidated about the borrowing relationship, the Chairman and directors have with their banks and are severely constrained in exercising their normal judgement and control over such relationships.

On the subject of the independence of directors a quote from Frank Brebeck from Pricewaterhouse Coopers who recently talked to the industry on Corporate Governance in Europe is profound. He said –

" A director is considered to be independent when he is free from any business, family or other relationship – with the company, its controlling shareholder or the management of either – that creates a conflict of interest such as to jeopardize exercise of his free judgement" (Franck Brebeck, PricewaterhouseCoopers, 2005)

In exercising this independence some of the imperatives must, perforce, be

- Sufficient time: How many directors spend sufficient time on the affairs of their banks? Even Board meetings are not attended. One hears of a classic case of directors of a banking company who have not attended any board meetings for 2 years with no action having been taken under the company's own governance rules to vacate them! These directors serve on at least 25-30 other companies so it is little wonder that they just do not appear at all at some board meetings. Their nomination as Directors was obviously to ensnare dominant shareholder interest and for no other purpose.

- Limitation on number of directorship: Apart from banking companies, where no limitations have been specified in the law, it is a common sight to see directors functioning on over 10 to 15 companies at the same time. It is humanly impossible for directors to serve effectively on the number of boards they are simultaneously on. This has gone to such an extent that in some instances, it has become a joke and cannot be taken seriously at all. Is there such a dearth of professionals and persons of integrity that we find the same people serving on so many corporate boards? It is the responsibility of directors too to decide on how many boards they can serve effectively on and to decline all others. Should everything be mandated by law ? Don't we have principles and responsibilities as individuals? What about the inevitable conflicts of interests that arise out of these diverse directorships?

- Disclosure of other significant commitments: In banking companies, this is mandated by law. The Company Secretary should obtain a declaration of all related party interests and is meant to ensure that a conflict of interests is strictly avoided.

The conduct of bank auditors too, who are appointed by the shareholders and who have an auditor-client relationship are an integral part of, and are a reflection of, the standards of corporate governance in financial institutions. Auditors of licensed banks are obligated by banks to carry out a statutory audit and can be removed from the panel if the Central Bank is

not satisfied with the quality of their audit. It was publicly acclaimed at a recent forum that auditors who find themselves constrained in their independence or unable to exercise their responsibility as auditors, should walk away from such client relationships rather than compromise their standards by acquiescing on blatantly contentious matters or by taking refuge under various audit concepts. Auditors of banking companies too have a moral responsibility to the public that must be seen to be discharged. This responsibility cannot only be cast on the regulators. Today, the world over the “true and fair” opinion given by auditors has become the manthram of the audit profession. The writer is firmly of the view that audit firms of banking companies in particular and, indeed, of other companies as well, should change at least once in five years to ensure the independence of audits. The fact that a new set of eyes will be looking at the books will ensure more vigilance and better quality audits. There is no incentive for vigilance if audit firms are never changed which may result in cosy, complacent relationships developing between auditors and clients, which, in certain instances, have even seriously compromised auditor independence, to the detriment of the public interest. The argument proffered by the audit firms that this will give rise to “teething” problems is weak and is a reflection on the ability of auditors to take on a new assignment. The compromise offered, of changing the audit partners, is of little consolation, as indeed has been the experience, in that, whoever the Partner, the culture of the audit firm prevails and nothing is achieved. The Sarbanes-Oxley Act, post Enron, deals, inter alia, with auditor independence. After all, the global corporate scandals were so profound that they wiped off one of the largest audit firms from the face of this earth. This is similar to the crash of Barings Bank in the most sophisticated financial centre in the world. In a more than a 100 year old bank, it took a rogue trader a few clandestine deals, in highly sophisticated Singapore to crash a bank that had weathered the physical onslaught of two world wars!!!!!!. This then is the destructive power of lack of integrity and ethics.

Sarbanes Oxley comes down heavily on auditor independence, albeit post facto, and demands increased disclosure on, inter alia, executive compensation, insider trading and financial statements. When can Sarbanes Oxley be applied to the fullest here? It is talked of so much but very little is done about its virtues. No speech in the financial system in this little island is complete without the mention of Sarbanes-Ox. But there is still a long way to go to walk the talk, on matters such as disclosure of executive compensation of any corporate in Sri Lanka. Why is this so, as is the case with most non-disclosures? Whatever disclosures are made today have been mandated by law and are not voluntary. This is also because the ownership of most listed companies is not sufficiently broad-based to ensure shareholder independence strong enough to demand such disclosures. A controlling mafia of shareholders very often looks after the interests of a few major shareholders. On the other hand, executive compensation in the western world is so transparent that it is even debated in the media. In that respect, Sri Lanka will always be in the third world and unless the standard setters think it fit to enhance the quality of disclosure, our regimes will always be looked down upon. This is also a throwback from our culture, from our attitudes - a culture of inferiority dating to our history of colonial dominance.

In Europe they are moving towards even greater transparency of directors’ remuneration, full disclosures of remuneration policy and procedures, disclosure of individual remuneration package and the shareholders’ opinion on policy and overall remuneration package. This would apply naturally to the CEO and senior management as well. This is because of the public

perception that directors are not independent, they are overpaid and that they do not fulfill their responsibilities.

The Cadbury Report on Corporate Governance included a series of recommendations on the role and constitution of audit committees, which are reiterated by Sarbanes-Ox and which is enshrined in our Code of good corporate governance issued to the Banks. The Board Audit Committee is a vital corporate governance tool whose usefulness and effectiveness cannot be overemphasized. Sri Lanka too initiated several steps to promote Corporate Governance especially within the financial system, in view of the corporate scandals taking place on the international arena. A Code of Corporate Governance was issued to Banks and Financial Institutions to promote voluntary adoption of such standards by these institutions. In addition, amendments were incorporated to the Banking Act in order to ensure the quality of a Bank's Management. Part V of the Banking Act No. 30 of 1988 (as amended from time to time), clearly specifies that directors, chief executive officers and other officers performing executive functions in licensed commercial banks should be determined to be 'fit and proper.' The recent amendments to the Banking Act, provide the Monetary Board with greater powers of enforcement. Today, the Monetary Board is empowered to remove a person from the office of director if it is found that he is not 'fit and proper' to occupy that position.

Another grey area in governance is the ESOPs (employee share owning plans) that are a common feature in most banking companies. These are invariably funded by the banks themselves and is not deemed to be capital until they are actually paid for. If not, it would result in the Banks financing their own capital. The law prohibits such financing but a 10% leeway has been permitted by law. However, on prudential grounds, ESOPS are not taken into the computation of a Bank's capital,. Be that as it may, we would be treading on dangerous ground if Directors and senior management who are privy to confidential information on key decisions of the bank ,on a day to day basis, are permitted to trade in these shares. They should be permitted to be held only for the purpose of dividends and not for capital gains. It not only overcomes the issues of insider trading but also provides the directors with an incentive for efficient bottom-line performance. The most recent high-profile case in this regard should have prompted a response from the standard setters and regulators and it is still not too late to prevent such abuses of privilege.

Banks which promote good corporate governance, restrict trading in shares of the bank by the staff during times which are considered sensitive. Directors/ CEOs of banks are privy to confidential information on a daily basis; information which even in the form of rumours could influence the share prices. This raises the question of whether Director's participation in ESOPs is in keeping with the best standards of corporate governance and business ethics.

The onus of establishing good Corporate Governance standards and a Code of ethics and implementing it within the institution, rests on the shoulders of the Board of Directors and no other. It clearly drives home the fact that elaborate Corporate Governance Standards and Codes of ethics/conduct cannot ever replace the responsible behavior and good business ethics of a Director.

As advocated by Sir John Bond, Group Chairman of HSBC, in Madrid in 2004,* a carrot and stick approach might help move the industry in the right direction. Differential supervision would be

the carrot where banks with a good track record would be allowed a longer rein; more rigorous regulatory standards would be imposed on banks with poorer compliance records. The stick would be more"public naming and shaming", just to encourage better behaviour. He strongly believes that in spite of, or perhaps because of, recent corporate scandals, reputation will be one of the defining characteristics in a company's success in the 21st century.

***(At the International Conference of Bank Supervisors in Madrid, Spain in September,2004.)**

(The views expressed in this note are purely those of the writer in her personal capacity and are not necessarily those of the Central Bank of Sri Lanka)

Joan de Zilva Moonesinghe FCIB.,AIB (SL)

Joan de Zilva Moonesinghe is the Director of Bank Supervision, Central Bank of Sri Lanka. Her experience in bank supervision spans quarter of a century. She is a visiting lecturer on Bank Supervision at the Joint Vienna Institute, Vienna, on behalf of the Financial Stability Institute, Basle, Switzerland. She has served as a panelist and as a speaker both here and abroad, on a cross-section of subjects dealing with prudential regulation and supervision.

During her long tenure in the Department of Bank Supervision of the Central Bank, Joan has participated actively in the drafting, enactment and implementation of the landmark legislation in Sri Lanka's financial system – the Banking Act No. 30 of 1988 and its subsequent amendments. She had a handson involvement in the resolution of the global failure of the BCCI and its repercussions on the Colombo Branch and has participated in the resolution and restructuring of other weak banks in the industry right up to the exit from the industry of the failed Pramuka Bank.