Address by Mr Yandraduth Googoolye, First Deputy Governor, Bank of Mauritius at the Workshop on Corporate Governance organised by the Mauritius Institute of Directors, Port-Louis, 11 January 2013

Ladies and Gentlemen

A very good morning to you.

I would like to thank the Mauritius Institute of Directors – the MIOD – for organizing this Workshop on Corporate Governance and inviting me to speak before such a distinguished audience.

I understand that this is the second Workshop in this series – the first one was held in November last year at this very same venue and due to the vast interest expressed by its members, the MIOD had to organize this second workshop.

Corporate Governance is turning out to be a very topical issue indeed ! Not only in Mauritius, but worldwide. International standard setters like the Bank for International Settlements and the OECD, among others, have recommended that bolder initiatives be taken to promote higher corporate governance standards in organisations. These initiatives, as you all know, were driven mainly by the corporate governance failures and lapses noted during the global financial crisis.

The crisis has shown that there is not only the need for banks to improve their corporate governance practices, but that supervisors also must ensure that sound corporate governance principles are thoroughly and consistently implemented.

But why should banks be subject to more stringent rules than other companies ? One would be tempted to ask.

Well, simply because banks play a critical role in the economy. They are highly leveraged institutions and most of their funds come from depositors – regulators cannot condone that a customer loses his money on account of lax corporate governance standards being maintained in institutions they regulate. Regulators have the ultimate responsibility of ensuring the safety and soundness of the financial system while at the same time safeguarding the interests of the depositors and the public at large.

Hence, it is vital that this special position of trust that banks have in the economy is maintained through principles of good corporate governance. And it is within the remit of the regulators to make sure that these principles are effectively adhered to by banks. Predictably, the best option available to the Bank of Mauritius to ensure that these best practices are being adhered to in the banking sector is to prescribe them in the form of Guidelines.

In fact, as far back as 2001, the Bank of Mauritius issued the first Guideline on Corporate Governance, which shows that corporate governance has always ranked high on our agenda. The first Guideline, however, provided only a broad framework of corporate governance whereby banks were advised to put in place a set of parameters without being prescriptive enough.

The growth and increasing complexity of banks domestically coupled with the sad experiences which unfolded during the financial crisis, however, heightened the need for the Bank of Mauritius to revisit the codes and principles of corporate governance governing banks.

As you all know, the history of banking contains many examples of banking crises. You may recall the high profile failures such as Enron and Parmalat and nearer to us, the failure of banks in the global financial crisis largely attributed to failures in corporate governance and risk management practices and the underpinning poor corporate culture and ethics.

In response, many standard setting bodies and banking supervisors around the world have revamped their corporate governance standards requirements and reassessed their adequacy. Whilst these changes may have increased the burden of regulated financial institutions, they provide a safeguard for the financial system as a whole.

The Bank of Mauritius has also kept pace with the evolving best practices set by international standard setters and issued a new Guideline on Corporate Governance in August 2012.

This Guideline, I must say, was released to the industry after rather lengthy consultations with the banking community and the public at large. The Guideline was issued for public consultation in November 2010 and it was finalized after nearly two years. The Bank of Mauritius adopted a collaborative approach on this front and discussion groups were set up with banks. We even received comments from the MIOD for which we are very thankful and we thank everyone who participated in this initiative. I must emphasize here that the new Guideline has been finalized taking into account the specificities of the local context.

Let me now run you through the broad principles underpinning the Guideline.

The financial crisis has shown that in certain instances, the Board – which plays a significant role in safeguarding the corporate governance principles and is ultimately responsible for overseeing the organization and management of the company's affairs as well as the individual board directors were simply unaware of and did not understand the risks taken by the businesses which they were supposed to oversee. Other factors in corporate governance breakdown were attributed to conflicts of interest, lack of board director independence, weak internal and external audit practices and deficient internal control systems. Moreover, the complexity of the organisational structure of some financial firms impeded transparency and disclosure so that the firms' true conditions were not visible to external parties such as regulators and market participants.

The new Guideline on Corporate Governance has thus, attempted to circumvent these shortcomings and uphold the three principles underpinning good corporate governance, namely integrity, transparency and accountability.

The Guideline emphasizes the responsibility of boards, their accountability as well as that of the Chairperson who leads the Board. The *quality* of the people sitting on boards and comprising senior management of financial companies has a direct bearing on the way these institutions are managed. The Guideline, therefore, whilst ensuring that directors meet the fit and proper person criteria, further prescribes for the leadership skills enhancement of board directors. Poor leadership has undermined public confidence in financial institutions during the crisis and has provided many painful but precious leadership lessons to one and all. The

Orientation Program for Directors outlined in the Guideline addresses the issue of leadership by ensuring that directors are fully conversant with the principles of leadership, and the leadership training programme has to be approved by the Bank of Mauritius. I am pleased to announce that this Workshop has been duly approved by the Bank.

The crisis also brought to light the importance of inculcating a corporate culture which promotes ethical principles. Culture has been described as '*the way human beings behave together – what they value and what they celebrate.'* The banking crisis revealed a breakdown of the values that promote trust and led to a crisis of confidence in banks.

Regulation can propel a change in culture when it is otherwise not feasible, as rightly expressed by the Chief Executive of the UK, Financial Services Authority who stated that the regulator can influence culture by '*influencing the composition of management, influencing incentives for good behaviour, influencing training and competence regime and deterring poor behaviour*.'

The Guideline on Corporate Governance, thus imposes the responsibility on directors and senior management to lead by example in an environment that emphasizes trust, integrity, honesty, judgment, respect, responsibility and accountability. Culture can only be effective when combined with strong leadership. For corporate governance principles to be really effective, the tone must be set from the very top of the organization in order that these principles trickle down to the lowest level of the organization to ensure compliance. The board should actively sustain an ethical corporate culture in the organization. Further, strategic plans and procedures have to promote ethical balance, fair dealing practices must be applied, and a code of ethics must be laid down and communicated to all the members of the organisation.

The Guideline on Corporate Governance not only draws from lessons learnt from the crisis, but also aims at addressing corporate governance weaknesses identified in financial institutions during on-site examinations conducted by the Bank of Mauritius and which have not been remedied in line with the recommendations of the Bank of Mauritius. While the 2001 Guideline recommended for a rotation of directors, it was noted that this recommendation has not been implemented to the satisfaction of the Bank of Mauritius. It was found that some boards remained "Pale, Male and Stale" as Governor Bheenick remarked during the first Workshop. To remedy that, we had no other alternative than to limit the term of office of non-executive directors of local banks to 6 years with a cooling-off period of two years before a possible re-appointment. This would allow for more fresh blood in the Boardroom with new ideas, new mindset and, why not, bolder initiatives. Renewal of board members allows new thinking on the board. Nevertheless, we are alive of the need to maintain continuity at the Board level and banks have been granted a transitional period to comply with that provision.

In addition, on the issue of directorship, it needs to be highlighted that while the Bank of Mauritius is mandated under the Banking Act 2004 to allow a director to sit on the Board of more than one financial institution, we have taken the view that there is a potential risk of conflict of interest, if we were to allow this. We also believe that all directors should allocate sufficient time to perform their board responsibilities effectively.

The Chairperson of the Board must be an independent director under the Guideline. This requirement is based on the principle that effective board debate and discussion require independent board leadership. A strong presence of independent directors implies independent judgment, free of any external influence.

The board is further encouraged to appoint a lead independent director. The lead independent director has a potentially major role to play within the board, if there is a potential or actual tension between the Chairman and CEO or, alternatively, where the closeness of the Chairman and the CEO might inhibit the ability of non-executive/independent directors to challenge and to contribute effectively to the works of the board.

As regards the various sub-committees of the boards, the Guideline makes it mandatory for financial institutions to have an Audit Committee, a Conduct Review Committee for related party transactions and a Risk Management Committee. Board sub-committees represent the arm of the board for those issues that require special competencies. The sub-committees should report regularly and formally to the board which should stand ready to challenge any key issues as the board bears the ultimate responsibility.

Corporate governance principles also require the bottom-up flow of information to the board through independent control functions such as the internal audit, compliance and risk management functions. However, the onus remains on the board to ensure receipt of management information as appropriate for the exercise of its oversight responsibilities. We may recall that the global financial crisis revealed weaknesses in corporate governance practices of failed banks where information on the real risks being taken by the institution did not reach the board or even senior levels of management. Even if risk management systems are functioning, the absence of transmission of information to the board and senior management would constitute a breakdown of corporate governance principles. Approving strategy is not sufficient, suitable metrics must be set to monitor the implementation of strategy and the responsibility for such monitoring falls on the board.

Internal Audit and Compliance are two independent assurance functions which constitute the eyes of the board in matters of internal control as well as legislative and regulatory compliance. Whilst the Banking Act 2004 already elevated the Internal Audit function in the organization by giving it a direct reporting line to the Audit Committee, the Guideline on Corporate Governance has now enhanced the value and importance of the Compliance function by prescribing that it has a direct reporting line to the board or a board committee. This function has the responsibility of ensuring compliance with legislative and regulatory requirements as well as policies and procedures. Moreover, a compliance certificate has to be delivered by the board to the central bank on an annual basis as we want to ensure that the board is assuming its compliance oversight responsibilities over the activities of the institution.

It would be remiss of me, if, in a talk on corporate governance, I did not mention the role of external auditors. The latter provide an independent opinion on whether the financial statements of the bank are complete, fair and properly drawn up with a true and fair view of its affairs. They will also draw attention on any significant matters identified during the course of their audit work. We view auditors as partners in our quest to have safe and sound institutions and expect the highest standards from them.

Excessive risk taking by employees and compensation based on short term profitability have often been a serious hit to the banks. Weaknesses in these areas contributed to the failures of financial institutions during the crisis where remuneration systems were not related to the strategy and risk appetite of companies and served more the self-interest of bankers rather than the long term interest of the financial companies. To address this issue, the guideline recommends that incentives be designed to discourage such practices and remuneration for executives, directors and key personnel be fair and reasonable.

The Bank of Mauritius will ensure that the provisions of this Guideline are being complied with. In fact, compliance thereto will be factored in the computation of the CAMEL Ratings of banks which are published on the Bank's website since 2011. The CAMEL Ratings comprise an assessment of the following components : Capital, Asset quality, Management, Earnings and Liquidity. Four of the five components, namely the Capital, Asset Quality, Earnings and Liquidity, are based on objective criteria, i.e. data submitted by banks in their returns to the Bank of Mauritius, whereas the Management component is based on subjective criteria many of which are contained in the Guideline on Corporate Governance. The Bank therefore, expects financial institutions to comply with the provisions of the Guidelines, as non-compliance thereto will have a bearing on the Management component in the CAMEL rating of banks.

On this note, may I conclude by commending the initiative of the MIOD to organize this workshop and assist stakeholders to better understand the Bank's Guideline on Corporate Governance. I am confident that participants will benefit from it. May I also congratulate the Institute for its relentless efforts to improve professionalism and ethics in our corporate entities.

I thank you very much for your kind attention.