# Corporate Governance in the Banking Sector

***Speech by Mr B.R. Gujadhur, Managing Director, Bank of Mauritius at the Workshop of the Commonwealth Association of Corporate Governance,***
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Good Morning

A survey of banking problems in Europe over the period 1988 to 1998 showed that the fundamental causes of failure of banks were both management and control weaknesses. Whereas management failure belongs to the domain of poor decision-making, control failures are structural and relate to the area of corporate governance. The main sources of problems were identified as incompetence, excessive risk taking, lack of integrity and unjustified pressure for short-term results.

More recently, the Federal Reserve Bank of New York carried out an economic policy study in 2003 to assess the nature of the relationship between corporate governance and corporate success. One of the findings of the study is that the size of boards is not a useful predictor of firm performance. In fact, one conclusion which emerged was that the bigger the board, the poorer the results. It was also found that different corporate governance structures are suited to different industries and that the concept of a 'one size fits all' code of governance is not suitable for different firms operating in different sectors or for companies of different sizes.

It emerges from these studies that the modernization of company law is a necessary but not a sufficient condition in developing the effective role of corporate boards. Express corporate governance rules would be required to keep under control broader risk issues and systems of accountability which, unattended, can lead to corporate collapses and loss of shareholder and creditor funds. It should not be assumed however that once codes of corporate governance have been put in place, board adherence thereto is automatically achieved. Far from it, in quite a few cases, old habits persist. There is also a mistaken perception that the various codes which have come into existence since Adrian Cadbury constitute a set of new rules on the lookout for problems to solve. This view is obviously incorrect since the codes address a common problem having to do with serious compliance issues arising from insufficient board oversight and structural flaws in the control environment of firms. So, they need to be seen as pre-emptive measures rather than prescriptions for failures that have occurred already.

**Role and Place of Banks in the Economy**

In the case of the banking sector, certain factors single out banks from other financial and non-financial firms in the matter of corporate governance. Banks are closely connected with systemic financial stability by virtue of their key role in the economy. They perform two critical functions in this respect. They accept liabilities consisting of short term obligations which they match with longer term commitments in the form of credits and investments. This is referred to as maturity transformation, a factor which is at the heart of economic life in market economies. A second critical factor associated with banks is that they provide the key infrastructure to ensure the smooth flow of funds in the exchange economy. Failure of their effective operation of the country's payment system can affect dramatically the pursuit of economic activity. Banks fulfil this role essentially by providing money substitutes to the system, such as checkable deposits but advance in technology has added on a further dimension in their role as service providers to the payment system.

Accordingly, banks represent a critical component in the area of financial system stability. This aspect was sharply brought out in the decade of the 1990's when a series of financial crises struck various regions of the world. Entire economies were paralysed due to failure of financial intermediation and the risk of contagion threatened other parts of the world. The last of these crises, in East Asia, may have left deep scars. Steps are being contemplated even now by the concerned authorities to consolidate the resilience of their financial sector so as to avert any crisis on a similar scale which can have prolonged damaging effects on key productive sectors of the economy. These crises have highlighted how unprepared financial intermediaries were in the face of unexpected massive and volatile flows of funds out of countries, rocking the very economic foundation of entire regions. In the wake of these events, several bank boards were swept off or completely overhauled by the authorities in the hope that the new incumbents would better measure the nature of the problem and adopt timely solutions before putting at risk the very economic foundation of countries.

A major conclusion of the Federal Reserve Bank's study, to which I referred earlier, was that "a clear case can be made for bank directors being held to a broader, if not higher standard of care than other directors". This is because a wide variety of stakeholders from the full economic spectrum are concerned in the case of banks, including depositors, creditors, investor institutions, debtors and other institutions. Even through bank boards share with other firms the profit-making objective, board members of banks have to be alive to their broader "social responsibility" to the other stakeholders and thus pursue the profit motive by exercising appropriate checks and balances between the two pursuits. To be able to do so, they should have the necessary training and skills to understand and shoulder their special responsibility as directors of banks. Mere professional qualification or business experience is insufficient in keeping to this extra duty of care, as certain unfortunate events have amply illustrated from more recent international history.

Another aspect on which emphasis may be placed is that a serious bank problem may give rise to a wide ranging 'public interest' element, embracing a country as a whole. The regional financial crises of the 1990's have illustrated that failed corporate governance of banks has taken an even wider dimension putting at stake cross-border economic and financial stability beyond the boundaries of the individual countries of the concerned banks. The 'public interest' element in that case calls for cross-border accountability. Boards of banks should be equipped to assume this responsibility even in cases where the banks have limited geographic presence.

In view of global interdependencies however, the banking problem would be expect to extend even beyond regional economies, given complex economic networking across countries which embrace today the global economy as a whole. This factor has direct implications for the profiles that directors of banks having a significant international presence should be possessed of. Such externalities go beyond the narrow precincts of the individual boardroom. Increasing numbers of international standards on rules for the safe conduct of banking business reflect a recognition of this fact. It is the duty of regulators to bring to the express notice of the boards of banks the special risks associated with their institutions and, hence, the specific precautions to be taken to contain the risk within the context of internationally accepted standards of good behaviour in the sector. It should be noted that taking on new experience is also a relevant factor as far as corporate governance issues in the banking sector are concerned. Thus, we have only lately learnt from the Wolfsberg principles and the revised FATF on the more subtle reputational risks faced by financial institutions and banks in particular regarding the financing of terrorism. Ignoring these incremental developments can act to shift to the concerned banks an element of unknown risk that could result in substantial losses.

**Bank of Mauritius Approach to Corporate Governance in Banks**

Bank regulators step in to prescribe rules of corporate governance in a precise context. Their concerns are twofold: to ensure the performance of financial markets and to provide for the efficient functioning of the economic system. As banks have grown in size and scope, innovative techniques have been adopted by them, the effect of which has been to change the risk profile and the performance of various centers of profit within the banks. Complex risk management tools have been adopted by a number of banks the effect of which has been to overhaul dramatically the nature of business risk and its management. Conventional Boards and even audit firms have been overtaken, in some well publicized cases of bank company failures, in the exercise of their responsibility, or in understanding fully the complexity of the risk management processes put in place and the adequacy thereof. Consequently, bank boards which believe that they know fully the business they are entrusted with may have to take a fresh look at the way they have been controlling risks and the manner in which they should address the issue in view of changing circumstances. This is a continuing duty which can only be overlooked at the risk and perils of the banks which directors are entrusted with.

Corporate governance failures have been observed in various forms in Mauritius. The observed period dates back to at least the early 1980's. In certain classic cases, the dominant chief executive has subjugated Boards and, by so doing, extended incompetence across the whole bank. In other cases, he ended up incarnating the bank itself, leaving little or no substantive role to the Board. All too often, a number of Board members were little acquainted with the business of banking and therefore, unable to give direction, let alone understand and control the risks. There were cases of Board members being deliberately placed in positions of conflict with their duties as directors by unscrupulous Chief Executives. They were made to avail of facilities from the bank directly or indirectly in generous amounts. Once they failed to honour their obligations due to business downturns or borrowing in excess of requirements or diversion of funds to other than the stated purposes, they would not be capable of effectively discharging their responsibilities. Another consequence of such a situation was to heighten the level of risks endorsed by the bank due to the dubious quality of collateral taken by it to back the facilities. The accepted rule of prior disclosure of interest by the concerned directors was never tabled at the relevant Board meetings. In those cases where Board members had the necessary skills, their voice was made inaudible at the level of the Board as they were made to realize that they were easily replaceable.

There have been other cases where the Chairman of the Board failed to keep to democratic decision-making and assumed instead all the importance in the Board. In such circumstances, he was poised to lead the bank dangerously to suit his private business interests. The Chief Executive would, in such circumstances, become ineffective in the management of business within the overall control environment given by the Board. There have been other cases in which boards failed to pay due regard to information and advice coming from outside the bank either believing that they alone were the repositories of all relevant information or sometimes coming to depend entirely on the one-sided view expressed by Management on matters of governance until it was too late. Other Boards failed to apprehend fully the risk associated with poor strategies or considered that developing strategy for the bank was not part of their brief and that it was the concern of the Chief Executive. In so doing, they did not grasp the nature of risks being taken until poor strategy, or the absence of it, brought the bank to grief.

**Action taken by the Bank of Mauritius**

Against this background, the Bank of Mauritius issued the first guideline on corporate governance of banks in early 2001. The role and responsibility of directors was fully articulated, in addition to the structures of accountability that it was the duty of the Board to put in place to address the overall control environment to ensure the safety and soundness of the banks' operations. The guideline emphasizes the criticality of the functioning of the Board independently of Management, while at the same time imposing on it the duty to appoint and monitor management. Other than the normal fiduciary responsibility of directors, the guideline stresses upon the independent functioning of the board and the necessity for it to own up the overall stewardship of the bank. Two other guidelines, notably one on the public disclosure of information and another on related party transactions, were subsequently issued within the overall framework of corporate governance, setting out the means by which Boards could effectively exercise their duties in the area of governance.

The Bank of Mauritius approach to corporate governance in banks is designed to achieve public confidence in the banks through higher levels of transparency and accountability regarding Board action. Thus, boards of banks and management are called upon to present publicly their discussions relating to risk management policies, strategies and controls and corporate governance practices. To assist the Board reach clear conclusions on these matters, specialized sub-committees of the Board are indicated.

There are strong recommendations for the Board and Senior Management to put their act together for creating the required accountability framework for the bank's performance while still providing for a clear division of responsibilities between the two. The Board should be equipped with a reasonable knowledge of the nature of risks inherent in banking business and be up to mark to put to proof the abilities of individual directors to cope with the actual difficulties when they arise. The Board's job is to ensure the implementation of policies and systems which strike a good prudential balance between risks and returns. As regards management, it has a first level responsibility to implement a comprehensive risk management process which identifies, monitors and controls all types of banking risks. In this fashion, there is no sharp dividing line casting a doubt on the collective responsibilities of Board and Management as regards the risk management factor in the bank as a unified structure. The regulatory platform is based on a well articulated set of responsibilities up and down the entire business line and, hence, it provides for an integrated approach to maintenance of systems and risk controls by setting out neatly the responsibilities of Board and Management.

**Conclusion**

Does the independence of board members guarantee sound governance outcomes? To my mind, there is no sacrosanct rule which correlates the two factors. Independence, which is a desirable quality of Board members, especially the Board Chairman, cannot be equated with competence in all cases. Nor is independence a homogeneous product which can be applied in all cases with equal effectiveness. Individuals differ from one another. They may have the same background of skills but they may differ in terms of temperament. In the case of banks in particular, temperament may prove to be the critical factor especially when business runs into difficulty and apt decisions have to be eked out at board level in good time to avert a serious crisis that may have system-wide risk potential. In brief, it may be said that independence of bank directors is a necessary but not a sufficient condition for the best governance outcomes to emerge from bank Board deliberations.

Do shareholders bring up boards with the right qualifications and skills and how well do they ensure that conflicts of interest at Board level do not end up undermining shareholder value? There are several cases of insufficient shareholder activism, something which could have been extremely valuable in the case of banks given the latter's importance in the economic framework as a whole. Where appropriate action fails to be taken in a timely manner either because large or small investors in banks have other private interests to pursue vis-à-vis the bank or have put themselves in conflicting situations with it for commercial reasons, the level of risks tends to be heightened in the bank due to the passive role such investors would be expected to play at the level of getting the right directors to the boards of banks. A better but well balanced dose of shareholder activism should go to complement regulator actions with regard to better corporate governance in banks. This will require the concerned shareholders to be sufficiently detached in terms of their private interests in the bank and to recognize their undiluted wider role as general stakeholders in the economy.

Does the fact of putting in place codes of corporate governance automatically guarantee that banking companies abide by them? This is absolutely not the case. In certain cases, where boards pay lip service to the corporate governance framework by "fixing" risk management committees, audit committees, internal and external audit functions, etc., in the institution, just as a matter of compliance with regulatory requirements, no real substance is obtained in terms of governance. Such an attitude can be extremely dangerous in a bank environment, and no undue risk should be taken in this respect such as by doing the needful only when actual "accidents" take place. It may be too late to react at that stage. There is no substitute for full fledged and well functioning boards of banks which are convinced of the reality of the business assigned to them either as boards or sub-committees of the Board.

Finally, I may add that Boards that are effective, especially in the case of banks, do listen carefully to outside views, including those of the regulators. In so doing, they put themselves in a position to objectively assess the advice being tendered to them by Senior Management or by the regulators and to accept to review their approach to business risk management after a careful balancing of evidence. Pragmatic boards which are open to conviction and prepared to listen to alternative ways of seeing the bank's overall control environment are not always easy to come by. Nevertheless, this is the direction boards should take to avoid serious mishaps which, in the case of banks, lead to unforgivable situations.

A number of such practical considerations cannot get enshrined in company law or in codes of corporate governance. They are expected to arise instead from the awareness of risks, the stock of skills and the voluntariness of individual directors of the board in considering issues of substance. These individual capabilities and their exercise in the course of board meetings need not be practised solely because they have been prescribed in codes of good corporate governance or omitted if not so. Good practices at the level of the board draw rather on a personal code of good behaviour, a willingness to see the collective benefit as distinct from private profit and the desire to place the company in the mainstream of the best institutions in its category from anywhere in the world. No code of corporate governance would, to my mind, give the expected results especially in a sensitive sector such as banking unless it is firmly grounded in a sound personal code of ethics endorsed by every board member, explicitly or implicitly.

I thank you for your attention