Chapter 1

Introduction

1.1 What is Corporate Governance?

Governance is the focal point of today's efforts to improve life in entirety, quality of output, efficiency in delivery of products of an organization, and ensuring the best value for money. To govern means run, rule and dominate with authority in policies and procedures of an organization. It is synonymous to influencing and determining the course of action, while specifying the method of controlling the events and activities so that outputs is optimized in terms of quantity, quality and timeliness.

Both the theory and practice tell us that there is multiplicity of factors shaping governance of a business organization. Therefore, businesses need to be governed by a set of rules, which reflect interests of all stakeholders. These "rules of the game" for businesses are an important dimension of reform processes in both sophisticated/developed and developing economies alike. Countries that ignore or lag behind in corporate governance reform will rapidly find themselves at a competitive disadvantage in attracting long-term capital for growth.

Corporate governance, on one hand, is about setting up a system of entrusting the directors and managers with responsibilities in relation to running corporate affairs and, on the other hand, it is concerned with the accountability of those directors and managers.

The whole gamut of corporate governance lies in concepts like transparency, accountability, merit, ethics, fairness and responsibility in following terms:

Transparency: Through checks and balances like; Auditing Committees, External and Internal audit systems, which are free of interference by decision makers.

Accountability: All who have enjoyed power through a strong set of rules are answerable to sponsors as well as society.

Mapping Responsibility: Both vertical and horizontal, so that responsibility is taken by those who make the decisions.

Disclosure: In a company nothing should be hidden for long and without reason. Once a decision has been made, it should be known to all.

1.1.1 <u>Defining Corporate Governance</u>

There are multiple definitions of corporate governance. Some popular definitions are as following:

> *"A set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."* (OCED)

> *"It is a system by which companies are directed and controlled."* (Cadbury Committee)

> *"Corporate governance includes every force that bears on the decision-making of the firm, that would encompass not only the control rights of stockholders, but also the contractual covenants and insolvency powers of the debt holders, the commitments towards employees, customers and suppliers, the regulations and the statutes. In addition, the firm's decisions are powerfully affected by competitive conditions in the various markets in which it operates."* (Prof. Kenneth Scott of Stanford Law School)

We may define it as follows;

> *"Corporate Governance is the system by which business corporations are directed and controlled by structuring rights and responsibilities of different participants in the corporation, such as, the board, managers, shareholders and stakeholders. By doing this, it provides structure for setting corporate objectives and mustering resources to attain those goals without compromising fairness, ethics, transparency and accountability."*

Another simple definition would be;

> *"Corporate governance signifies the manner in which business and affairs of the corporations are directed and managed by their Board of Directors and Senior Management."*

Hence, corporate governance may be taken as a mother-term dealing with issues arising out of the interaction among stakeholders. In any organization 'Board of Directors and Management' are the main decision making bodies occupying the center of decision making process. Ideally, they cherish to serve the interests of all stakeholders. Here, the notion of stakeholders means sponsors, employees, customers, suppliers, regulators, government and the society – an organization works for and live within.

1.2 Why Corporate Governance?

Corporate governance has never been more central an issue than now. It belongs to all – individual banks and the industry as a whole. Now the survival of organizations depends on complete adherence to 'Good Corporate Governance' only.

Many forums and organizations have issued governance codes and guidelines to help governments, organizations and individuals ……[in] their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. (OECD)

Banks are critical components of an economy. They are custodians of public money. They provide financing for commercial enterprises, basic financial services and access to payments system. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. Banks function only when depositors, borrowers, and the society have full confidence in the banking system and the sanctity of banking transactions. It is crucial, therefore, that banks have strong corporate governance.

In this context, the sudden interest in Corporate Governance we are witnessing in banks, is fully justified. In the last few years a number of committees and forums have issued principles and codes – the Cadbury Committee document, the OECD Code, Combined Code of London Stock Exchange, the Blue Ribbon Committee in U.S, and the Code of Corporate Governance issued by SECP in Pakistan.

Standards and codes developed recently have highlighted the need for banks to set strategies for their operations and establish accountability for executing these strategies. Furthermore, the formula 'Everyone-Must-Know' the existing condition, decisions made and actions taken, is integrally related to accountability in the sense that market participants get sufficient knowledge to make judgment regarding management of a bank.

In Pakistan, we have passed first stage of drafting the code of corporate governance (SECP has issued Code of Corporate Governance, SBP has issued many Prudential Regulations/instructions for improving corporate governance). Our pace is satisfactory and we are making progress. Down the road challenges are: to design appropriate evaluation and monitoring mechanisms, to enforce accountability and to have early warning systems which automatically triggers prompt corrective actions. Bottom line is that every institution, participating in the financial system, should configure governance with accountability.

1.2.1 Reasons; why this subject has gained so much importance:

- To educate the public and to promote better understanding of essential corporate governance principles;
- To provide the board of directors and the management with adequate powers to be exercised in clearly defined line of responsibilities so that they stand accountable to the shareholders in the pursuit of maximization of value for the company.
- To promote induction of independent, non-executive company directors with diverse background and experience;
- To recognize issues of maintaining continuity of management through succession planning, identifying opportunities, facing challenges and managing change with the business and appropriate allocation of resources.
- To encourage corporations to adopt internationally accepted accounting principles, standards of financial disclosure, conflict of interest disclosure, antitrust laws, bankruptcy laws;
- To optimize matrix of incentives, checks-and-balances, communication, fairness, disclosure, transparency, business ethics and social responsibility. It intends to balance economic and social goals and individual and shared objectives.
- To make corporations feel the need of good corporate governance in a globalized world where perception of both international and local investor is driven by management structures and credibility of business. In such an environment, corporations must proactively design their culture specific codes and actively implement, instead of sitting and waiting for rules to be imposed from external constituents.

Besides these reasons following bank-specific developments push us to focus our attention on corporate governance in banks:

- Worldwide campaign for financial sector liberalization, deregulation and privatization leading to a variety of models of ownership and management. Banks now offer a number of products through different delivery mechanisms. This is a complex situation demanding ground rules to be clear and rational.

- Networking and integration of financial institutions among themselves as well as with other industries has complicated the economic landscape which is loaded with systemic risk of institutional failure. We have free market place where only shared interest is profit maximization. In this state of affairs, good corporate governance should come in action to set rules of the game.

- The world is now smaller due to progress in technology. It is volatile and inter-linked. Money instantly flows around. A mistake in one part of the financial world rapidly spreads and effects the whole system. The best way to identify and block this flow of dirty money, every country needs to interface its banking system with the international grid according to best standards and practices of corporate governance.

It is beyond doubt that for any system to demonstrates good corporate governance it needs integrated efforts of Regulatory Agencies, Professional Boards, vigilant shareholders and enlightened leadership to come into action.

1.3 Incentives available for the players of this game

Following are the incentives for embracing best corporate governance standards;

- **Individual banks** and those who own and manage them, adoption of internationally accepted governance standards will help them to achieve their corporate aims

- **Banking industry,** as a whole, can, by increasing compliance in the banking system, attract depositors, borrowers, counter parties and the investors.

- **Shareholders** ensure that their sponsorship is adequately protected against all risks and wealth is multiplied.

- **States** (means: regulators) will strengthen banking sector and, therefore, their economies and discourage fraud and mismanagement.

- **Society** at large makes sure that total social reward is maximized.

1.4 Why this book?

Volumes have been written on corporate governance by management and business experts. Committees, regulators and several other organizations have issued their principles and codes.

State Bank of Pakistan is publishing this handbook with the objective of reinforcing importance of adoption of good corporate governance and to assist bankers, auditors and public at large to understand the subject. SBP has strong interest in ensuring that there is sound corporate governance at every banking organization. Supervisory experience around the world underscores the need of having the appropriate levels of accountability and checks and balances within each bank to contribute to a collaborative working relationship between bank management and bank supervisors. Sound corporate governance makes the work of supervisors relatively easier. This work is an attempt to make banking institutions safe, sound and efficient and, therefore, increase confidence in the banking system.

It should be remembered that corporate governance extends beyond corporate laws and this compendium, which is a consolidation of relevant laws, regulations and directives, should not be considered an end in itself. Nor should we think that its only objective is mere fulfillment of the requirements of law, as it aims at earning commitments of the board and the management in running the company in a transparent and ethical manner for multiplying shareholder value. It is pertinent to mention here that corporate governance must not be taken as enactment of legislation rather what is desired is setting up of an environment characterized by trust, confidence and transparency.

If something can be done – in terms of better internal controls, better auditing practices, enhanced disclosure, more transparency of policies – then objective should be: Do it immediately.

1.5 Highlights of basic tools for sound corporate governance

- Appointment of key personnel after ensuring that they are fit and proper for their jobs;
- Promotion of corporate values, ethics, codes of conduct for appropriate behavior and institution of a system to ensure compliance with them;
- Articulation of corporate strategy against which success of overall enterprise and the contribution of individuals can be measured;
- Assignment of clear-cut responsibilities and decision-making authorities, and outlining chain of required approvals from individuals to the board of directors;
- Institution of a forum interfacing the board of directors, senior management and the auditors;
- Putting in place sound internal control system, including internal and external audit functions, risk management functions, independent of business lines;
- Special monitoring of situations where conflict of interest arises, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the bank;
- Offer of incentives (monetary and otherwise) to management (senior, business line) and employees in the form of compensation, promotion and other recognition; and

Channeling flow of information both within and outside the organization (the public).