CORPORATE GOVERNANCE IN THE FINANCIAL SECTOR

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I would like to address the following four questions in my presentation this morning:

(a) **Why do we require Corporate Governance in the Financial Sector?**

(b) **What does Good Governance Involve?**

(c) **What has been done so far in Pakistan?**

(d) **What are the Challenges Ahead?**

Why do we require Corporate Governance in the Financial Sector?

Corporate Governance has become critical for all entities and, therefore, the codes of Corporate Governance or legislations are being adopted increasingly by the organized sectors in the developed and developing countries. However, there are some additional reasons that are unique to the financial sector which necessitate attention to this issue. These are:

- The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in banking systems.

- The failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed.

- Private sector banks are motivated by profit maximization and their own financial stakes are limited and relatively low and they are therefore prone to excessive risk

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taking with the depositors' money. Strong corporate governance is, therefore, required to discourage them from following this course.

What does Good Governance Involve?

- The Board Members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns

- The Board must play a leadership role in approving the objectives, strategy and business plans of the bank, monitoring the performance of management and ensuring that the internal control and risk management systems of the bank are effective. The strategy, vision, missions, goals and the values should be communicated throughout the organization.

- The Board must also make sure that the Bank conducts its affairs with integrity and in accordance with high ethical standards. The Board is part of the system of checks and balances that ensure that neither large shareholders nor management abuse their power and that decisions are taken with the Bank's best interests in mind. If the Board does not play its full part, a vacuum in leadership will be created. This vacuum may be filled by the shareholders becoming directly involved in running the Bank's affairs or by the Executive Management acting more or less in isolation. In either case, the Board of Directors is bypassed and checks and balances are lost.

- The day-to-day running of Banks should be left in the hands of the Management but the Board should set and enforce clear lines of responsibility and accountability throughout the organization. The Board must also ensure that there is appropriate oversight by Senior Management.

- The Directors should have fair understanding of the banking business, the nature of its risks and its strategic direction. It should be clear that ultimate responsibility for ensuring that risks are properly identified, monitored and controlled lies in the Boardroom.

- There is considerable importance attached to having an adequate representation of non-executive and independent directors on the Board and a clear separation of the position of Board Chairman and Chief Executive Officer.

- Directors should ensure individually and collectively that potential conflicts of interest are avoided or, at least, managed in ways that do not compromise the interests of the company.

- Rigorous and independent internal and external audit arrangements are at the heart of corporate Governance debate. The work conducted by internal and external auditors in performing an important control function should be effectively utilized by the Board in discharging its oversight function.

- Strong emphasis should be placed on regular, timely, comprehensive, meaningful and reliable financial disclosures of affairs. This disclosure should specify the following information:

    - Board structure (size, membership, qualifications and committees);

    - Senior management structure (responsibilities, reporting lines, qualifications and experience);

    - Basic organizational structure (line of business structure, legal entity structure);

- ➢ Information about the incentive structure of the Bank (remuneration policies, executive compensation, bonuses, stock options);

- ➢ Nature and extent of transactions with affiliates and related parties.

<u>What has been done so far in Pakistan?</u>

- Prudential regulations defining the Responsibilities of the Board of Directors have been issued and enforced.

- Fit and proper test for Chief Executive Officers (CEO's), Board Members and key Executives have been laid down. Those who do not fulfill the criteria laid down in the test are not allowed to hold the respective office.

- Minimum Disclosure requirements (quarterly and yearly) have been prescribed for banks.

- Family representation on the Boards has been limited to 25 percent and the remaining Directors have to be independent non-executive non-family members.

- Securities & Exchange Corporation of Pakistan (SECP) Code of Corporate Governance has been applied to banks/DFIs (where no conflict with the State Bank of Pakistan's (SBP) Guidelines/Directives).

- Conflict of Rules have been explicitly laid down barring stock brokers, money changers, etc. and all those having any potential conflict from becoming involved in the management and oversight of banks.

- A Handbook on Corporate Governance for Banks/DFIs containing International Best Practices and SBP's Instructions on the subject has been compiled, published and disseminated.

- A Conference on Corporate Governance for Chief Executives and Board Members of Banks/DFIs was organized to train them.

- An Institute of Corporate Governance has been established and the SBP is among its Founder Members.

- Corporate Governance requirements for Banks/DFIs are continually reviewed to adopt internationally recognized best practices.

- External audit firms are screened, categorized and rated for the purpose of auditing the financial institutions. Wherever they are found deficient, they are de-listed or even black-listed.

- The impact of these measures could be summed up as follows:

  - Market players are disciplined.
  - Risk Management has improved.
  - Quality of Board Members and Chief Executives is taking a turn for the better.
  - Ingredients of a stable banking system are taking roots.
  - Self Regulation is beginning to take shape.

<u>What are the Challenges Ahead?</u>

The most pressing challenges facing the banking sector arise mainly from the adoption of Basle II Accord and consequential management of risks. Early adoption of the Basle II Accord presents an unparalleled opportunity for banks. Those that embrace the new standard will find they enjoy a distinct competitive and high-performance advantage in international markets. Idle capital is freed up, ready to be put to best use. The main challenges ahead are:

- Induction and retention of highly skilled human resources and keeping their skills in hone will be the number one priority for all of us – the regulators, the shareholders, the educational institutions and the Chief Executive Officers. In this respect, those of you who are aspiring to join the financial sector have to equip yourselves with the knowledge, skills and attitudes required for professionalism. The difference between the successful and not so successful graduates will lie in the acquisition for life long and continuous learning. Those who keep up with the times and strive to improve themselves throughout their career, through learning, will have bright and promising future. Those who become smug and complacent and adopt short cuts may have immediate gains but will find it hard to survive in competitive financial markets over the long run.

- The other challenge is that the banks will have to automate and reengineer their business processes, move to E-banking and multi channel delivery modes and use technological solutions to reduce transaction costs providing satisfaction to the customers. The record of the banking system in adoption and diffusion of technology has been mixed so far but greater efforts will have to be made in the future.

- Credit, market and operational risks should be identified, quantified and mitigated instead of dealing with credit risks only as was the case under Basle I. Strong Internal Rating Systems and Management Information Systems are essential for managing these risks

- The increased transparency provided by Basle II means that clients, regulators and investors all will have a clear understanding of the institution's operations. Consumers and commercial clients will benefit from more timely and accurately assessed lending decisions leading to increased customer satisfaction and loyalty in a highly competitive market. The fog created by best guesses has to be replaced by an objective historical track record and reliable data on which future decisions can be made. Regulators will also have access to stronger sets of historical data and transaction trails for detailed examination and policy decisions. Finally, investors will reward banks that capitalize on the advantages afforded by the Accord.

- Market discipline will have to be strengthened to make governance effective in Banks. Credit ratings, listing on the Stock Exchanges, raising funds through capital markets are some of the mechanisms that can fortify market discipline.

- Lower capital requirement for lending to good rated borrowers will improve the overall Governance emphasis amongst the corporations.

- Good internal controls will be established which are essential for capital assessment process.

To conclude, good Corporate Governance is something we have to live with and in the financial sector the imperatives are even stronger than the rest of the corporate sector. In Pakistan, we have made a modest beginning but the challenges ahead are still quite daunting. We have to continue the journey on the path we have chosen i.e. to strengthen the Corporate Governance in our Financial Sector.