Corporate Governance[1]

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Distinguished Guests, ladies and gentlemen, I welcome you all to the State Bank. I would like to express my deep gratitude to our foreign guests who have come from long distances to share their experiences on the very important topic of corporate governance. We also have with us very eminent personalities from the financial sector of Pakistan, whose illustrious careers bear testimony of their strong understanding of various issues facing the financial sector of Pakistan today, including the topic under discussion. With such an august gathering, we hope to see a spirited debate in the ensuing sessions on various issues relating to the implementation of good corporate governance practices among banks in Pakistan.

I. Overview

Corporate governance is a uniquely complex and multi-faceted subject. Devoid of a unified or systematic theory, its paradigm, diagnosis, and solutions lie in multidisciplinary fields i.e. economics, law, finance, agency theory, accountancy, etc. As such, it is essential that a comprehensive framework of corporate governance is codified in the accounting and auditing, legal, and regulatory framework of any organization.

In the recent past, the frequency and incidence of corporate scandals has grown world wide. Among these, a series of bank failures stemming from weaknesses of financial sector regulation and supervision manifested themselves in regional financial crises such as those witnessed in Latin America and more recently in East Asia in 1997. These episodes have destabilized governments, crippled economies by wiping out economic gains, resulted in loss of investor confidence, and aggravated poverty. Developed countries, despite their relatively greater financial capacity to absorb the shock and impact of high profile collapses of firms like Enron, World Com and Parmalat etc. have taken strong notice of the instances of failure of corporate governance, and have fundamentally reformed their corporate governance standards and discipline, while enforcing laws against the misuse of financial transactions.

Developing and emerging markets, on the other hand, have an added dimension in their evolving corporate governance framework : these economies embarked on the liberalization and deregulation of their financial systems as recently as the 1990s. The financial crises experiences by such countries have been caused in part by excessive exposure concentration, directed lending, lending to connected parties, poor credit policies and inadequate management of foreign exchange risks. These problems reflect poor management of conflicts of interest, inadequate understanding in the boardroom of

[1] Keynote Address at the Conference on Corporate Governance, hosted and organized by the State Bank of Pakistan, Pakistan Institute of Corporate Governance and International Finance Corporation, held at State Bank, Karachi, on May 29, 2006.

key banking risks, and poor oversight by boards of the mechanisms for managing their banks, such as risk management systems and internal audit arrangements. In some cases, the absence of truly independent directors on the boards of banks was also a significant factor in weakening the effectiveness of such boards. These problems were compounded by poor quality of financial disclosures and ineffective external audits, lack of auditor independence and indulgence of audit firms in a range of non-audit services for their clients.

It is amply clear that emerging economies have yet to fully adopt and implement corporate governance frameworks. Understandably then, their ability to absorb unexpected shocks is not at par with advanced economies. This enhances the need to uplift corporate governance standards in such economies to minimize their vulnerability to exogenous shocks, and also to take fuller advantage of the opportunities offered by the free interplay of market forces.

With this brief introduction, I now propose to lay down the conceptual framework for corporate governance of banks, highlighting :

- how it differs from the corporate governance of other companies
- the special considerations that require a broader scope and approach to banks' corporate governance
- its strategic dimensions

At a later point, I will elaborate on the measures taken by the State Bank to strengthen the corporate governance framework for banks and assess their impact on the performance of the banking industry.

II. Corporate governance of Banks – Conceptual Framework

Efficiently run banks serve to effectively mobilize and allocate funds that in turn helps to lower the cost of capital to firms, boosting capital formation and productivity. To the extent the banks operate like "firms", with shareholders, boards, debtors and competitors, the framework of corporate governance of banks is akin to that of a conventional firm. However, In contrast to enterprise-based firms, commercial banks play a role in: (i) safeguarding and protecting the liabilities of depositors; (ii) recycling assets; and (iii) risk taking and effective risk management, as banks tend to be highly leveraged relative to other types of firms. The unique role of commercial banks in liquidity generation, as financiers and appraisers of businesses, and in devising project finance structures for companies requires a broader and more elaborate governance framework.[2]

Given these special attributes and the complex role and functions, agency problems in commercial banks are characteristically and structurally different from those of enterprise-based firms. Strict enforcement of internal corporate governance norms in banks is required to preserve shareholder value. Exclusive reliance on addressing the principal-agent problem between owners and managers is not sufficient because banks operate businesses that require taking different types of risks, and because of the

[2] See Jonathan R. Marcey and Maureen O' Hara: *The Corporate Governance of Banks,* Economic Policy Review, Federal Reserve Bank New York, 2003

dynamic relationship between banks, the corporate sector, and the market at large. Furthermore, the principal-agent problem in banks is unique in the sense that owners or majority shareholders can collude to be a source of moral hazard.

As mentioned earlier, relative to other companies, banks are highly-leveraged companies characterized by opacity of assets and activities, and information asymmetries which makes it difficult to align the interests of the management with equity and debt holders. The domination of family ownership in corporates and banks nurtures insider abuses at the expense of outside minority shareholders, depositors and ultimately the tax payers. Governance of banks also varies if government continues to retain the ownership. Asia still tends to have a number of jurisdictions where the government owns majority of banks, particularly in the People's Republic of China and smaller transition economies.

Banks face a wide range of complex risks in their day-to-day business, including risks relating to credit, liquidity, exposure concentration, interest rates, exchange rates, settlement, and internal operations. The nature of banks' business - particularly the maturity mismatch between their assets and liabilities, their relatively higher gearing and their reliance on creditor confidence - creates particular vulnerabilities. Banks are further prone to arbitraging, and innovatively treating debts, while hedging real risks.

The deregulation of the banking sector, its markets and operations has unleashed strong forces of competition. This has forced banks to be more aggressive in leveraging and risk taking, and more innovative in terms of technology, products and work processes. While the increased competition introduces efficiency and sophistication in operations, it also brings with it a high degree of systemic risk which can have serious repercussions.

In view of the above considerations, the scope and approach to bank's corporate governance requires a different and specific regulatory setting and banks need to be examined, evaluated and analyzed differently than other corporates. As such, there is need to recognize the merits of adopting a threefold approach that advocates:

(i) Strengthening governance at the enterprise and bank level,
(ii) Strengthening the ability and incentives of investors and depositors to demand and exert governance, and
(iii) Empowering and equipping regulators to develop and enforce regulations effectively.

Banks' governance is critical not only because of its benefits to shareholders and depositors, but also because effectively governed banks are more efficient and prudent in directing their resources. Furthermore, the stability and solvency of both the financial and the corporate sector has enormous implications. If a corporate defaults or one bank fails its effects transmit from one bank to another which prompts a systemic crisis that has economy wide or global implications, both financially and socially.

To shareholders, corporate governance is the maximization of shareholder value by striving for profits, and for banks it is the containment of various types of risks typical of banking operations, and to raise firewalls that not only enable proper risk assessment but also prompt early corrective actions to avoid failure.

Corporate governance depends on the interplay and efficacy of internal and external factors, structures and systems. Among internal factors, it is most crucial to recognize: (i) shareholders' rights, (ii) the role of stakeholders, such as customers, employees, suppliers and creditors, (iii) composition, roles and responsibilities of the Board, (iv) role of audit, and (iv) disclosure and full transparency. External factors that influence a corporate governance regime involve the competitive, operative and legal environment in the country. In this broad architecture, the Board singularly has a significant and a strategic role to set goals and objectives, while Management ensures their implementation through efficient utilization of resources. Good corporate governance requires the Board to keep a hawk's eye on the management and affairs of the bank, and streamlining incentives to strengthen internal management, ranging from protection of shareholder rights, while encouraging transparency and competitiveness through:

- Checks and Balances: Audit committee, external and internal auditing systems, which are independent of decision-making on credit and borrowings;
- Clear division of responsibility : both vertical and horizontal, so that responsibility is taken by those who make the decision;
- Disclosure and Transparency: so that nothing stays hidden for long, once a decision has been made;

Bank regulation, whose primary concern is to prevent systemic instability, alters the parameters of the agency relationship by introducing a third party, the 'regulator',[3] that serves as an additional external force to ensure that banks act and operate prudently. It is through the regulation and enforcement mechanism that the regulator disciplines bank behavior that in turn deters corporate borrowers from over-leveraging their operations. To limit systemic risks and the potential for financial instability, regulators are provided with a mandate to rescue "too big to fail" banks by serving as the *lender of last resort* to circumvent temporary liquidity crises, and developing *deposit insurance schemes* that protect and insure small deposit holders. The merits of "lender of last resort" and "deposit insurance schemes" have been widely debated. A major issue has been that these measures, although they may help prevent bank runs, often encourage inefficient and/or high risk lending practices.

Depending on how a regulatory regime is structured and implemented, it can either strengthen or distort the incentive mechanisms for the corporate governance of banks. The Bank of International Settlements (BIS) has developed a set of core principles that, if effectively complied with, should help mitigate risks. The BIS principles specify, amongst others, standards for bank-specific entry and exit; fit and proper test criteria for owners and managers; and mechanisms for monitoring and controlling risks associated with moral hazard and adverse selection. These core principles are complemented with guidelines for "*Enhancing Corporate Governance for Banking Organization,"* issued in 1999 by the Basle Committee on Banking Supervision, which have been updated in 2006 and elaborate on standards required of banks' boards of directors to help strengthen the corporate governance of banks.[4]

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[3] See P. Ciancanelli and J. Anotonio Reyes Gonzalez: "*Corporate Governance in Banking: A Conceptual Framework"*, Department of Accounting and Finance, Strathclyde University, Glasgow, UK. Paper submitted at the European Financial Management Association Conference, Athens, June 2000.

[4] Core Principles for Effective Banking Supervision, Basle Committee on Banking Supervision, February 2006.

III. Pakistan's Corporate Governance Framework

(a) Legal, Regulatory and Institutional Framework of Corporate Governance

Since most banks are now listed companies, they fall under the Securities and Exchange Commission of Pakistan's (SECP) Code of Corporate Governance for Listed Companies. This code is applicable to banks/DFIs regulated by the SBP except for clauses that come in conflict with the directives issued by SBP. Enhancing this code, SBP has further defined the corporate governance requirements for banks through a set of other legislation and regulations. For instance, the Banking Companies Ordinance (BCO), 1962 amplifies further the internal governance requirements. It includes the rules for Board of Directors (BoD) appointments/dismissal, disclosure of share ownership, dividend policy, appointments of external auditors etc. Further instructions in these areas are provided in the set of Prudential Regulations (PRs) issued by SBP. Most critical in this context is the guidance provided on the role and responsibilities of BoDs; the Fit and Proper test criteria has been prescribed for Chief Executive Officers, Board members and key executives. This criterion is in addition to the minimum qualification requirements.

All banks are required to raise their minimum capital to Rs 6 billion ($100 million) by 2009. This would have far-reaching impact on the performance of the banking system as it would lead to further consolidation and consequent emergence of stronger banks to meet the challenges of the growingly complex financial environment.

Bank regulations, in conformity with the international standards, define ownership restrictions whereby regulations further bar stock brokers, money changers, etc. from becoming part of the management and oversight of banks.

SBP has issued guidelines on internal controls to promote an effective internal control system as an integral part of guidelines for risk management systems. SBP is among the few central banks in developing countries which have set very high standards of disclosure for their banks. This is expected to promote transparency in the affairs of banks, and would help minimize the hazards of asymmetrical information and adverse selection.

To ensure effective understanding among stakeholders, SBP has issued a Handbook on Corporate Governance for Banks/DFIs containing international best practices which provides SBP's approach and instructions on the subject. A conference on Corporate Governance for Chief Executives and Board members of banks was held to fully raise awareness of corporate governance and the Pakistan Institute of Corporate Governance (PICG) was established, with SBP as one of the founding members of the Institute.

(b) Bank Supervision

SBP has made considerable progress in strengthening its capacity to cope with the new challenges emerging from growth and diversity of the financial environment. Currently the central bank is taking stock of its own internal governance and benchmarking its performance on this count. Once this task is completed we will deliberate on recommendations for strengthening the internal governance of SBP with its Board.

SBP has developed and plans to implement a new surveillance system i.e. the Institutional Risk Assessment Framework (IRAF). The system has been designed to capture the host of risks facing individual banks based on the information gathered from on-site, off-site inspections and market intelligence. There is also implementation of the Reporting Chart of Accounts (RCOA) to capture critical data (on-line) from banks, which will not only lower the reporting burden on banks but also will promote transparency and standardization of data reporting for effective supervision.

SBP closely monitors banks' compliance with variable CAR which is based on the rating assigned by the Internal Risk Assessment Framework (IRAF) to each bank depending upon its financial condition. This implies introduction of a more sophisticated risk-based approach.

Finally to strengthen the risk management framework, SBP is steering the implementation of Basel-II in a phased manner. In doing so, SBP has already carried out the spadework for the ultimate implementation of Basel-II. In this respect, banks are initially required to adopt the Standardized Approach for credit risk and the Basic Indicator/Standardized Approach for operational risk from 1st January 2008. Subsequently, once they have improved their in house systems, they would switch over to more advanced approaches from 1st January 2010 subject to the concurrence of SBP. In addition, introduction of state-of-the-art analytical techniques to carry out a proactive assessment of the financial health of banks include stress testing and formulation of a Risk-Assessment Model. Once completely operational, the new systems will give a great boost to the supervisory capabilities to forestall or minimize the impact of developing strains.

The Financial Sector Assessment Programme (FSAP) of the IMF-World Bank has endorsed Pakistan's compliance with majority of the international codes and standards. Compliance with international best practices signifies the presence of a sound and satisfactory financial system, which connotes enhanced resilience to unexpected shocks.

Regulatory measures are now in place to curb practices of anti-money laundering as well as terrorist financing*:* These measures make SBP compliant with the recommendations of international bodies to prevent these high risk activities. Some of these measures include :

- A comprehensive set of regulations on *Know Your Customer (KYC), Customer Due Diligence, Suspicious Transactions Reporting and Correspondent Banking* has been put in place in line with the recommendations of the Financial Action Task Force (FATF). Accordingly, the SBP has issued directives to banks /DFIs to determine the true identity of every prospective customer, together with a minimum set of documents to be obtained from new customers/account holders of various types.

- All transactions of a suspicious nature are required to be reported by the banks to SBP, and after due analysis such cases are handed over to the National Accountability Bureau (NAB) or other relevant authorities for further action.

- Previously, a large chunk of foreign remittances were routed through informal channels like *Hundi* and *Hawala* which were facilitated by the money changers. To curb this practice, SBP took serious action and money changers have since then been brought under the formal regulatory ambit by converting them into exchange companies. Now these companies are subject to similar regulatory requirements as invoked for other financial institutions such as capital requirements, KYC requirements, proper record keeping, periodic reporting to SBP, and above all, on-site examination by SBP. Consequently, the volume of remittances routed through the formal channels has been significantly improved.

- Close co-ordination and co-operation with national and international agencies and training of bankers and regulators in the areas of Anti-Money Laundering (AML) and anti-terrorist financing.

- In order to further consolidate and strengthen AML/CFT regime in Pakistan, a separate law on AML is presently lying with the parliament.

The consequent improvement in the regulatory and supervisory functions has resulted into enhanced vigilance over banks' operations and has enabled SBP to enforce the regulations more diligently. We seek a detailed response in the form of a questionnaire from banks to assess their compliance with the corporate governance principles. The same is validated by thorough examination through on-site inspections, and anomalies are reported in the inspection reports. This, inter alia, has also influenced the compliance levels pertaining to corporate governance.

(c) Compliance with Corporate Governance

To ensure compliance with the code and supportive legal and regulatory framework, SBP has increased communication and dialogue with the management and boards of bank, in addition to enhancing its vigilance on banks to verify compliance with SBP's established values and principles of corporate governance and to advise before hand on the weaknesses and emerging problems entailing systemic repercussions.

Efforts made by SBP and the banking industry have yielded results in bringing about a positive change in the banks' corporate governance practices. Banks are now managed and run by a better cadre of professionals, and stakeholders now actively participate in the affairs of banks. The Boards meet regularly and participate in both setting the strategic direction for their institutions and providing the desired oversight. Managements at majority of banks are equipped with professional competence and a high degree of integrity. The increasingly intense competition among banks has resulted in improved and swift decision-making processes. Outside pressures have been marginalized. Financial reporting standards mirror international best practices resulting in enhanced disclosure and transparency. Governed by an elaborate corporate governance framework of the regulators, banks have displayed a high level of eagerness to up-grade their systems.

A quick glance at the different corporate governance practices adopted by banks brings to fore the following major areas where banks have shown increased, albeit slow, compliance with the existing codes and standards:

- Banks seek prior clearance from SBP for the appointment of members of BoD and CEOs;
- Banks follow the Fit & Proper Test criteria for the appointment of the key executives who should not be holding an office in another financial institution;
- The scope of the Board's policies has been enhanced to cover a broad range of areas such as internal audit and control, risk management, human resources, credit, investments, etc.;
- Boards now include experienced non-executive directors;
- Boards meet more frequently;
- Banks record detailed minutes of the Board meetings;
- Boards constitute specialized committees with well-defined objectives, authorities and tenure, comprising of non-executive directors to review different critical functions;
- Banks ensure that the paid executive directors do not constitute more than 25% of the total directors on the Board;
- Banks ensure that their cross shareholding in other financial institutions does not exceed 5%;
- Directors of the same family do not get representation of more than 25% of the total directors on the Board;
- Auditors are appointed from the SBP's approved panel and they are rotated at an appropriate interval; and
- Banks publish and circulate on a quarterly basis un-audited financial statements of the banks along with the directors' review.

IV. Impact of Corporate Governance

Improvement in corporate governance has helped instill a high degree of financial stability. These developments have to be assessed in the backdrop of a fast expansion of the balance sheet of the banking system. From end-CY02 to end-CY05, the overall balance sheet has recorded a growth of 64 percent, which in all respects is quite significant. Deposits of the banking system have registered an unprecedented growth of 69 percent since 2002. Credit activities got a tremendous boost as banks responded zealously to meet the sharp rise in the demand for credit. Loan portfolio of the banking system has doubled in the last three years. Unlike past trends, the loan growth was fairly diversified. This led to a substantial increase in the exposure of the banking system to newly emerging sectors like consumer, agriculture and SMEs.

Despite the fast expansion in the high risk-weighted assets during this period, the banking system has successfully kept up its solvency profile. This was made possible because of the heavy capital injections by a large number of banks to meet the enhanced minimum capital requirements, and was also supported by the ensuing high profitability. Consequently, Capital Adequacy Ratio (CAR) of the banking system remained stable at 11.3 percent (as against 8.8 percent in 2002), well above the regulatory requirement of 8 percent throughout these years.

Profits of the banking system scaled new heights. Return on assets (after tax) increased to 1.9 percent in CY05 from 0.9 percent in CY02.

Despite the fast growth in credit, and the increasing exposure to relatively new sectors, incidence of default has remained very low. Non-performing loans (NPLs) have declined gradually, reducing the lingering overhang on the operations of banks. NPLs to loans and net NPLs to net loans ratios have declined to 8.3 percent and 2.1 percent in CY05 from 21.8 percent and 9.9 percent respectively in CY02.

The net result of greater compliance with corporate governance standards is the higher level of the performance of the management of banks. As of end-CY05, the key management performance indicators of the banking system confirm the impact of strengthened corporate governance and risk management practices within banks. For example:

- Intermediation cost has fallen to 2.7% as compared with 3.4% in CY00;
- Average earnings per share has increased to Rs 5.7 from Rs 3.2 in CY03;
- Deposits per employee rose to Rs 30.2 million from Rs14.2 million in CY00;
- Assets per employee increased to Rs 39 million from Rs19.1 million in CY00;

Conclusion

Pakistan fares well vis-à-vis its South Asian neighbors in terms of introduction of the corporate governance standards across the corporate and the banking sector. Compliance and implementation of codes and standards has been however slow and patchy. While the regulators have laid down ground rules, relative to other countries the role of private sector in augmenting corporate governance standards has been limited and enforcement of codes has been weak. There is a strong need for the industry to

- galvanize and self regulate itself to bring about far-reaching and sustainable changes in corporate governance practices;

- adopt greater disclosure and improve shareholder rights;

- enhance the quality of Boards and their role in oversight. This involves ensuring effective independence of Board members and ensuring that they effectively discharge their duties, while staying away from day to day management and operational matters. In this context, hiring the services of consultants at the banks' expense to act as de-facto Board members is not a good practice and needs to be stopped. Additionally, Boards need to be more actively involved in understanding and addressing risks threatening the solvency of banks including weak internal control systems, audit functions, and checks and balances. Independent audit committees can help in translating audit reports into meaningful action, both corrective and preventive;

- Effectively manage the conflict of interest. The Boards should establish high standards of professional conduct to prevent malpractices including abuse of authority and conflict of interest in the wake of rapidly changing contours of the financial sector. A combination of market discipline supplemented by mandatory disclosure of conflicts and supervisory oversight are generally considered necessary to prevent the exploitation of conflict of interest;

- Adopt corporate social responsibility programs which aim to promote a vision of accountability to a wide range of stakeholders, besides shareholders and investors. In this context, the Boards should also be responsive to the welfare of its employees, community and civil society and to environmental issues.

This list of issues is by no means exhaustive. To fully institutionalize corporate governance, additional efforts are warranted. The goal of achieving high productivity would remain elusive if the corporate governance standards are flawed and not implemented properly. Rules cannot be a substitute for character. The rules can guide only a small number of the day-to-day decisions required of corporate management. The rest are governed by the personal code of values corporate managers bring to the table. In this context, banks should strive to build a reputation for honest and fair dealing while interacting with their internal as well as external stakeholders. The competition for reputation would invariably require strengthening of corporate governance standards. In future, those banks are expected to marshal power in the growingly competitive market which have a strong reputation of fulfilling their promises and meeting their clients' expectations.