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# Nasser Saidi: Economics & Governance

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## Financial Crisis And the Corporate Governance Solution

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**Financial Crisis & the Corporate Governance Solution:**

**Moving Forward on Remedies**

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The ongoing financial crisis poses a series of challenges to policy makers and regulators as they attempt to stabilise financial markets and prevent a meltdown and avoid the slide of the global economy from its deepest synchronized recession in 60 years into possible depression. The political and popular backlash is eliciting and promising deep banking and financial sector reform, including in the Bretton Woods international financial architecture and a wave of regulations, encompassing corporate governance.

At the most basic level, the current crisis stemmed from excessive risk taking for short-term profit by senior managements in highly leveraged banking & financial institutions. Boards were not fulfilling their obligations in ensuring the sustainability of their operations. Regulators were failing to provide satisfactory oversight of a system that provided incentive to leverage through securitisation and sent the wrong prudential signals through the pro-cyclicality of capital adequacy and value-at-risk measures. In other words, the crisis originated from failures on three principal levels: the senior management level, board level and on the regulatory level. More fundamentally it is about mal-governance and disrupting incentive structures. Importantly, it did not originate in faulty macroeconomic fundamentals, though global imbalances resulting from large US current account and budget deficits are contributory factors.

In these testing times, we need to rethink the overall system, its architecture and incentive schemes; but we must also bear in mind that many of the technical solutions exist and arguably by proper implementation of corporate governance best practices, the crisis could have been avoided or its consequences mitigated.

Effective reform measures come from sound analysis and understanding of the unfolding financial crisis. Corporate governance is defined as the mechanism through which companies are controlled and directed. It is ultimately based on identifying responsibilities and establishing quality information flows and clear reporting lines in an overall framework of transparency and accountability. It is often characterized as a system of checks and balances between the senior management, the board and the regulator. But for the mechanism to work successfully there needs to be an alignment of incentives and interests. The implementation also needs to be comprehensive and rooted within the overall business culture and structure, i.e., measures developed in isolation (or elsewhere) may not enable the achievements of the desired objectives.

***Role of CG in restoring confidence and building markets***

In light of the near meltdown of markets, the key objective is restoring market and investor confidence. Markets exist by the grace of traders and investors. Our way out of the crisis is through intelligent regulation, one that does not pre-empt or hinder market driven adjustments, but supports and strengthens financial

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innovation and the market, and does so through creating and maintaining a culture of transparency and accountability.

From the perspective of regulators, this means three things. The regulators need to ensure that they themselves are both transparent and accountable, that their responsibilities are well-defined and not conflicted, that they are not subject to political intervention or 'regulatory capture' and that they are staffed with competent and experienced personnel. You cannot regulate what you do not understand! Good corporate governance like well organised charity starts at home. Regulators should develop and implement governance guidelines on good practices for regulators as promoted by the Bank for International Settlements and International Organization of Securities Commissions. Juvenal's *Quis custodiet ipsos custodes*? Or "Who Watches the Watchmen?" requires an urgent answer.

Secondly, a major lesson is the need to extend the regulatory powers of central banks to investment banking and related non-bank financial intermediation. The high volume of financial product engineering that preceded the current financial crisis led to a dramatic increase in financial intermediation outside the core banking system – in the so called grey banking sector which was subject to little or no regulation. The financial turmoil has highlighted the interconnectedness of financial institutions. The complexity of markets, instruments and financial institutions and balance sheet interconnectedness requires a corresponding supervisory net. Regulatory gaps need to be filled to prevent regulatory arbitrage and abuse.

Thirdly, regulators need to impose and ensure compliance with mandatory corporate governance principles in the banking sector, whether conventional or Shari'a compliant. Governance principles for the banking sector should also be stricter and reflect a higher level of standard from a sector that is regulated, leveraged and benefits from deposit guarantee schemes and other publicly provided financial safety net provisions. Banks dominate the financial systems in our region and play a key role in the credit and investment process that is so vital to economic development. Good governance can play a critical role in the process of building strong domestic financial markets. It increases public confidence in the securities markets, improving liquidity and enhancing bank, corporate and sovereign ratings. Strengthening corporate governance in the banking sector will also extend better corporate governance to the firms they lend to.

Financial institutions and listed companies need to address their board structures, and pay special attention to any concentration of power. The roles of chairman and chief executives should be separate and the boards need to comprise sufficient if not majority independent non-executive representation to protect shareholder interests. In particular, critical board committees such as the audit, risk management and remuneration committees should be composed of independent non-executive directors.

The competency of board members should also be addressed. Directors should be appointed through formal and rigorous appointment processes based on merit and against objective criteria, having regard to succession plans. Directors need to have relevant experience and know-how to enable them to address the current and, in particular, future challenges of the business. Critically, they also have to be able to say 'No'!

Boards should see that conflicts of interest are avoided and if avoidance cannot be achieved in specific circumstances, conflicts should be identified, managed and, depending on their materiality, disclosed to the supervisor and, where appropriate, to shareholders in the annual report. Material related party transactions should also be disclosed, and there should be an outright prohibition on certain specific types of related party transactions, such as personal loans to board members and controlling shareholders.

The demise and losses incurred by institutions such as UBS, Citibank, Société Générale, Bear Sterns, Lehman and others was in large part due to risk management failure both internally and at the level of their board. Rigorous internal control processes should be developed and enforced. Sound risk management is built on a robust system of checks and balances, following clearly documented procedures and reporting lines. Professionally competent and independent internal and external audit functions are required to monitor and test the efficiency of the control system. Demonstrably, risk management failures are life threatening for the enterprise and are a major source of systemic risk. It is appropriate that regulators and boards are

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responsible for ensuring compliance.

Wholly independent remuneration committees should develop policies on executive pay and the total remuneration packages should be disclosed to, and approved by, shareholders. The financial crisis has made it evident how damaging remuneration practices can be if the wrong incentives are provided, and investors are increasingly pushing for remuneration packages that are risk-based, linked to long-term performance, relevant to the individual company's strategic goals, and consistent with sound corporate risk management.

Boards need to be encouraged to provide more transparency and public disclosure, and more specifically provide meaningful statements of their activities, not as a compliance activity, but to demonstrate awareness of risks and their skill in managing them.

Corporate governance should not be seen as a compliance exercise, but as a tool building competitive advantage to be exploited in that it helps boost and maintain shareholder confidence, but also provides the appropriate framework for preserving market integrity and the proper execution of compliance activities such as Anti-Money Laundering throughout institutions. Good governance, through improved transparency and accountability, facilitates the early detection of shortcomings and prompts adequate responses and thereby not only helps prevent crises but it also ensures that companies following best practices are more adaptable to any future regulations.

Earlier in the year, the UK government tasked Sir David Walker to review the governance arrangements in financial institutions. The Walker Review of Corporate Governance of UK banks and other financial institutions, which is now in the consultation phase, contains 39 specific recommendations in total on strengthening bank boards through performance evaluations and ongoing assessment of training and professional development needs, making rigorous challenge in the boardroom a key ingredient in decisions on risk and measures to encourage institutional shareholders to play a more active role as engaged owners of banks and other financial institutions. Hawkamah has been making similar recommendations for the past year, and it is important for regulators and policy makers in the MENA region to keep up the evolution of international best practices in corporate governance.

Given the current economic maelstrom, there is a strong case for "overshooting" in corporate governance, whether on the country or company level. However, regulators and companies should heed the warning that good governance is not a box ticking exercise. It is about companies embedding best practices at all levels of their organizations, starting from the top, from the Board, while governments set up proper enforcement mechanisms. One size does not fit all, but fundamental investor concerns need to be identified and addressed. Corporate governance improvements do not occur in a vacuum, but are often supported, incentivized, and facilitated by the regulator. It is likely that in the post-credit quake world, markets which will fare the best are those in which fundamental investor concerns are identified and addressed by the regulators and companies alike. Much lies ahead for us to do!

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