Corporate governance in the financial sector

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This article is an amended version of a paper prepared by the Reserve Bank of New Zealand for the Commonwealth Secretariat as a contribution to a technical assistance programme to strengthen corporate governance in the financial sectors of Commonwealth countries. It deals with the subject of corporate governance in the financial sector and the relationship between corporate governance and the management of banking risks. The article also summarises the Reserve Bank's approach to strengthening corporate governance in the New Zealand banking system.

1 Introduction

Recent episodes of financial instability have highlighted the potential fragility of financial systems and the effect that financial instability can have on the wider economy. In recognition of this, much international attention is now being given to understanding the causes and dynamics of financial crises and to developing policy frameworks for promoting robust and efficient financial systems. An important part of this work relates to corporate governance arrangements and the role that these can play in encouraging sound risk management practices.

This article discusses the key ingredients required for effective corporate governance in the banking sector, drawing on international standards and best practice. It also provides a brief summary of the New Zealand approach to strengthening corporate governance in the banking sector. For the purpose of this article, corporate governance refers to the arrangements that companies, including banks, have in place for their internal governance, including in respect of the identification, monitoring and management of their risks. Although the article discusses corporate governance as it applies to any corporate entity, the principal focus of the article is on corporate governance within banks and other financial institutions.

2 Financial instability and inadequacies in corporate governance

The world has seen many episodes of financial instability in recent years. In some cases, such as in parts of Asia in 1997/98, this instability caused significant dislocation to the wider economy, with severe consequences for economic growth and welfare.

Financial instability is caused by many factors. These vary depending on the nature of a country's economy and the structure of its financial system. However, some common causal factors include:

- rapid financial sector liberalisation unsupported by measures to encourage prudent risk management in the financial sector;
- unsustainable macroeconomic policies, such as loose monetary policy and excessive fiscal spending – such policies can contribute to asset price volatility and a subsequent erosion of asset quality in the financial system;
- exchange rate arrangements that lack credibility, including unsustainable exchange rate pegs - this is particularly important where financial institutions and corporations have come to rely on an exchange rate peg and fail to hedge their currency risk, only to sustain currency losses when the peg collapses;
- poor transparency and accountability arrangements for economic and financial policies;
- excessive degrees of connected lending (lending to parent companies and associated parties) and lending under the direction of government;
- industry protection and policies that impede the efficient allocation of resources in the economy;
- poorly designed and implemented banking supervision and prudential regulation, including insufficient structures to ensure that banks maintain a prudent level of capital relative to their risks and have robust risk management systems, insufficient scrutiny of lending quality and exposure concentration, and inadequate measures to constrain connected or directed lending;

- inadequate financial disclosure arrangements, including poor quality accounting and auditing standards; and
- weak market disciplines in the banking and corporate sectors, which tend to reduce the incentives for high quality risk management by banks and other corporate entities.

Although poor quality macroeconomic policy and economic shocks often play a major part in contributing to financial instability, it is fair to say that inadequate risk management within banks and other financial institutions is the root cause of most episodes of financial system distress. And a frequent underlying cause of poor risk management is inadequate corporate governance in the corporate and financial sectors. Weak governance in the corporate sector increases the risk profile of borrowing companies and exposes banks and other lending institutions to a greater risk of loss than would otherwise be the case. Weaknesses in corporate governance arrangements in banks and other financial institutions reduce their capacity to identify, monitor and manage their business risks, and can result in poor quality lending practices and excessive risk-taking.

Particular weaknesses in corporate governance arrangements in a banking system context can include:

- inadequately qualified and experienced bank directors, and directors with significant conflicts of interest;
- insufficient understanding of the nature of banking risks by a bank's directors and senior management;
- inadequate representation of non-executive and independent directors on the board (ie directors unconnected to parties related to the bank);
- inadequate risk management systems, internal controls and internal audit arrangements;
- insufficient structures for ensuring appropriate scrutiny and management of conflicts of interest, including those arising in business dealings between banks and related parties;
- insufficient accountability of directors for the stewardship of their bank;
- inadequate oversight of senior managers by boards of directors, and poor quality financial and risk-related reporting to the board; and
- insufficient rights for shareholders, including in respect of access to information and the ability to hold the board of directors to account.

Inadequate corporate governance is rarely attributable to any one factor; it generally results from a combination of factors. One of the more common underlying causes of poor corporate governance is insufficiently developed corporate governance law, including inadequate specification of directors' duties, insufficient clarity of the rights of shareholders and other stakeholders, and insufficient specification of the obligations for dealing with conflicts of interest. In addition, inadequate enforcement of corporate governance law – possibly as a result of poorly resourced judiciary and government authorities – can also impede the effectiveness of corporate governance.

Although inadequacies in the legal framework are often significant factors in weakening the effectiveness of corporate governance, a number of other considerations can also play an important role. These include inadequate development and promotion of a corporate governance culture by the relevant professional associations (such as a professional institute of directors or a banking industry association). At a more basic level, weaknesses in corporate governance in some countries can be attributable to a culture that attaches relatively little importance to the role of corporate law or to the observance of governance principles.

Excessively intrusive financial sector regulation and supervision also have the potential to weaken the incentives for effective corporate governance, by weakening market disciplines on banks and by diluting the responsibility of bank boards for overseeing the management of risks within banks. Similarly, poorly developed financial disclosure arrangements tend to weaken the incentives for the directors and senior management of banks to maintain sound corporate governance and risk management practices.

3 Promoting sound corporate governance

Given the effect that weak corporate governance and risk management structures can have on the management of risks in the financial and corporate sectors, it is important that steps are taken to promote effective corporate governance.

Promoting effective corporate governance in the financial sector generally requires a number of measures to be taken. These include:

- the development of an effective legal framework that specifies the rights and obligations of a company, its directors, shareholders and other stakeholders, specifies disclosure requirements, and provides for effective enforcement of the law;
- the development of a corporate governance culture, including through the development of corporate governance principles by professional or industry associations;
- the creation of an environment that fosters effective market disciplines, and thereby creates the incentives for sound corporate governance;
- maintaining appropriate banking supervisory arrangements, focusing on (among other matters) encouraging the adoption of sound corporate governance practices;
- training and educational initiatives to build capacity in corporate governance; and
- leadership by example, including by central government and regulatory agencies in terms of their own internal governance and transparency practices.

A number of these points are elaborated on below.

Effective legal framework

One of the important underpinnings of corporate governance in the financial and corporate sectors is an effective set of corporate laws setting out the basic legal rights and obligations of corporate entities and those of their directors, officers and shareholders. The legal framework needs to be clear and accessible, and needs to strike an appropriate balance among the interests of the various parties involved.

The legal framework will vary from country to country depending on various factors, including institutional arrangements and cultural factors, but in general, it could be expected to address such matters as:

- The powers and duties of directors, including: the obligations of directors in relation to setting the strategic direction of the company; obligations to ensure that the company's risks are being competently identified, measured, monitored and managed; and obligations to ensure that the affairs of the company are prudently managed.
- The need for directors to satisfy themselves that the bank or company is solvent (and likely to remain so) before making distributions to shareholders or otherwise taking on obligations.
- The rights and powers of shareholders, including rights in relation to voting and access to information on the company.
- Requirements for identifying and dealing with directors' conflicts of interest.
- The disclosure obligations of the company (including as to the preparation of financial statements, maintenance of accounting systems and audit arrangements). Company law could be expected to specify an obligation for directors to issue financial statements in relation to their company and the group of which it is part. In some countries, this obligation will mesh with a requirement for the financial statements to comply with particular disclosure standards, possibly including mandatory accounting standards, so as to encourage financial statements of high quality and comparability. In many countries, directors are held liable for ensuring that the company's financial statements and other disclosures are not false or misleading.

Corporate law also provides an important mechanism by which enforcement of corporate governance can be achieved. One of the functions of corporate law is to set out the penalties for non-compliance with corporate governance arrangements.

For enforcement to be effective, however, there is a need for more than an effective set of laws. There is also a need for a well-resourced government authority with the power and capacity to identify breaches of corporate law and a legal system and judiciary capable of facilitating effective enforcement, including through civil claims. The government agencies responsible for enforcement and the judiciary need to be accountable for the exercise of their powers. Accordingly, structures to facilitate their accountability should be in place, including transparency arrangements with respect to the nature and performance of their responsibilities.

There is a balance to be struck as to the level of detail of corporate governance requirements contained in statutory law. There are risks of excessive inflexibility, and associated compliance and efficiency costs, if statutory law contains an excessive degree of prescription. The level of prescription will depend in large measure on the extent to which non-statutory frameworks operate to promote sound corporate governance. All else being equal, statutory law can be less prescriptive where sound corporate governance practices are fostered by the existence of strong market disciplines, competitive markets, a corporate governance culture, and robust financial disclosure requirements, among other factors. Conversely, if these environmental factors are not strongly present, then this may suggest the need for a greater degree of prescription of corporate governance requirements in the law.

Developing a corporate governance culture – the role of corporate governance principles

Another mechanism for promoting sound corporate governance in the financial sector is the encouragement of a corporate governance culture through codes of conduct and principles of good practice. The development of corporate governance principles can play a significant role in promoting greater awareness and adoption of sound corporate governance arrangements. Corporate governance principles may be developed by industry associations, institutes of directors, government authorities, or other bodies, such as stock exchanges.

At an international level, a number of agencies have promulgated principles on corporate governance that can assist governments and private agencies in designing their own corporate governance codes of practice. The OECD Principles on Corporate Governance, the principles developed by the Commonwealth Association for Corporate Governance (CACG), the work developed by the World Bank and by regional forums such as APEC all provide guidance in these areas. The Basel Committee on Banking Supervision has also distilled some guidance on corporate governance as it applies to banking, in its paper *Enhancing Corporate Governance in Banking Organisations*.

Drawing on the work undertaken by the OECD, World Bank, CACG and the Basel Committee, a number of generic corporate governance principles can be identified, including the following:

- Directors should have the skills and experience necessary to perform their role effectively, and should have a sound understanding of the nature of the company's business and its risks.
- Directors should not accept a position on the board if they have conflicts of interest that would significantly compromise their ability to perform their duties.
- The strategic objectives of the company need to be clearly specified and the risk/return trade-offs need to be well understood and articulated.
- Directors need to satisfy themselves that the senior management team has the necessary skills and experience to perform its functions effectively, in the best interests of the company, and should ensure that there are structures in place for monitoring the performance of management.
- There should be a clear specification of rights for company shareholders, including rights relating to access to information, participation in general meetings, and the election of directors.
- There should be a clear specification of the powers, duties and obligations of directors, including the need for directors to act in good faith, with due diligence and skill, and in the best interests of the company.
- Directors should be obliged to satisfy themselves of the adequacy of their company's systems for identifying, monitoring and managing risks and that those systems are being applied effectively at all times. Effective internal audit arrangements, overseen by an Audit Committee of the board, should be maintained.

- The board should receive all the information they need in order to satisfy themselves that the company's affairs are being conducted in a manner consistent with the business objectives of the company and that all risks are being effectively managed.
- There should be structures to require a strong degree of accountability of directors to shareholders and other stakeholders of the company, and of management to directors. This includes the need for arrangements to facilitate effective communication with all categories of stakeholder, taking into account the information needs and rights of the stakeholders.
- The board should set key performance indicators for the chief executive and senior management team and establish a system for effectively monitoring performance.
- The board of directors should be subject to transparent rules governing conflicts of interest and related party lending, and board decisions in these areas should be disclosed.
- There should be robust financial disclosure and external auditing arrangements. In the context of banking, disclosure requirements need to be relatively specific, requiring regular public disclosure of a bank's financial performance, capital position, off-balance sheet positions, asset quality, risk exposures and risk management systems. Directors should be held to account for the veracity of disclosures.
- There should be structures in place to ensure that the company complies with all statutory and regulatory requirements.

The above principles are applicable to a wide range of corporate entities, and equally apply to banks. However, two specific features of banking suggest the need for a more intensive focus on corporate governance than might be necessary in some other sectors of the economy: their reliance on debt funding and the need to maintain the confidence of their creditors; and the complexity of their risks. These points are elaborated on below.

More than in most corporate entities, banks and many other types of financial institution are critically reliant on maintaining the confidence of depositors and other creditors. The economic welfare, and indeed survival, of a bank is very much dependent on maintaining depositor and other counterparty confidence.

The importance of creditors to a bank's welfare suggests the need for a bank to have corporate governance and risk management arrangements that ensure that its creditors' interests are being well looked after. Among other factors, this suggests the need for directors and senior management to be attentive to the possible conflicts that might arise between the interests of the bank's shareholders and its creditors. In general, shareholders' interests are best served by maximising the long-term present value of the bank, although often there is a tendency to focus on augmenting the short-term profit of the bank rather than necessarily focusing on the longer-term position. Creditors' interests are best served by the bank taking a somewhat more cautious approach to the management of its risks, such that creditors can be assured that their funds will be available in full upon maturity or on demand.

In practice, these conflicts can be managed effectively by adopting appropriately cautious risk management strategies and by focusing on managing the bank's affairs for the long-term interests of the bank, rather than focusing on short-term financial objectives. However, directors and senior management need to be aware of the potential for conflicts of interest to occur between the interests of shareholders and those of creditors and to have structures in place to manage these conflicts effectively, including in respect of:

- the choice between adopting higher versus lower risk lending strategies;
- the choice between maximising short-term profit results versus longer term stability;
- the appropriate level of capitalisation of the bank; and
- the appropriate level of connected exposures (to the parent company, other shareholders, and associated parties) and distributions to shareholders.

The inclusion of some independent, non-executive directors on the board of a bank will assist in managing the conflicts between the interests of shareholders and the interests of the bank's creditors. In particular, directors that are not connected with the parent entity or associated companies are likely to be better placed to identify potential conflicts between the shareholders and creditors' interests and to ensure that appropriate controls are in place to manage these conflicts. Independent, non-executive directors can also bring fresh perspectives and scrutiny to many aspects of a bank's business operations, including risk management systems, in ways that can supplement (and, if necessary, challenge) the views of senior management, executive directors and controlling shareholders.

Banks also differ from most other companies in terms of the complexity and range of their business risks, and the consequences if these risks are poorly managed. Banks face a wide range of risks, many of them complicated in nature, including credit risk, exposure concentration risk, connected exposure risk, interest rate risk, exchange rate risk, equity risk, legal risks, operational risks, defalcation risks, liquidity risks, reputation risks, payment system interface risks and business continuity risks. If these risks are poorly identified and managed, they expose the bank to the potential for financial collapse, particularly given the fact that most banks operate on a thin layer of capitalisation and have substantial maturity mismatches in their balance sheet. Therefore, banks need corporate governance structures that promote effective identification, monitoring and management of all material business risks. These structures may include:

- well developed and tested risk management systems and internal controls;
- training programmes for staff responsible for risk management, so that they have a well developed understanding and detailed technical knowledge of risks and the means by which they can be managed;
- training programmes for directors and senior management to enable them to have a sound understanding of the nature of the bank's business, the nature of the risks, the consequences of risks being inadequately managed, and an appreciation of the techniques for managing the risks effectively;
- robust internal audit procedures, with appropriate reporting lines to the CEO or directors, and with oversight by the Audit Committee of the board;
- a structure which requires regular reporting to senior management and the board on the nature and magnitude of the risks being carried by the bank and the structures in place to control these risks, including a regular assurance to the board that all risk management systems and internal controls are being properly applied at all times;
- structures to encourage bank directors to take responsibility for ensuring that their bank's risks are being effectively identified, monitored and managed, and that the systems in place to achieve this are operating effectively at all times;
- possibly requiring a bank's risk management systems and internal controls to be subject to periodic external review, and for the results of the review to be reported to the board.

Banks also need to comply with a large number of regulatory requirements, including prudential requirements, taxation rules, various reporting obligations and the like. There is therefore a need for the corporate governance framework to include systems for ensuring that all statutory and regulatory requirements are being complied with, and to highlight breaches if and when they occur.

High quality financial disclosure

An essential complement to sound corporate governance is the implementation of robust financial disclosure requirements for corporates and financial institutions. Financial disclosure is essential as a means of strengthening the accountability of directors and senior management and enhancing the incentives for risk management. It is also essential if market participants and observers – particularly the larger creditors of banks, financial news media, financial analysts and rating agencies – are to monitor the performance and soundness of financial institutions effectively and exercise appropriate disciplines on those institutions which do not perform well or fail to meet acceptable prudential standards. Financial disclosure is also essential if smaller creditors, including depositors of banks, are to have any chance of protecting their own interests, particularly in the absence of deposit insurance.

In recognition of the importance of financial disclosure, this issue is receiving considerable attention in various international forums. This includes the International Accounting Standards Committee (which has developed a set of international accounting standards), IOSCO (which is developing international disclosure standards for cross-border listing requirements), and the Basel Committee on Banking Supervision (which is developing transparency principles for application to banks). Moreover, the IMF and World Bank are placing greater emphasis on the need for countries to develop sound disclosure practices, as reflected in the broader focus of IMF Article IV consultations and the recently introduced Financial Sector Assessment Programme. The IMF/World Bank Reports on Observance of Standards and Codes (ROSC) is another process that may assist in encouraging the implementation of effective financial disclosure requirements.

Although the nature of financial disclosure and accounting standards will vary from country to country depending on institutional and legal arrangements, some broad principles can be identified. These are discussed below.

An effective set of disclosure requirements will need to be underpinned by robust accounting standards. These standards should desirably conform to international standards, although national modifications may well be appropriate. In particular, it is essential for accounting standards to set out meaningful frameworks for measuring credit exposures – preferably based on market values rather than on historic cost or other notional valuations. Accounting standards should also prescribe meaningful and reasonably specific rules for the recognition of income and expenses, for the recognition and classification of off-balance sheet exposures, and for the classification of assets and liabilities. In general, accounting standards should require the disclosure of financial information on the basis of economic substance rather than on the basis of accounting or legal contrivances.

Financial disclosures should be subject to rigorous external auditing requirements, based on a set of auditing guidelines promulgated by an appropriately qualified standard-setting body. External audit should be conducted by a fully independent auditor, whose business connections with their client should not be such as to compromise the auditor's objectivity and independence.

In some cases, banking supervisory authorities may supplement the standard auditing requirements with auditing requirements for unique application to banks. Modifications can sometimes include:

- a requirement for banks to undergo more frequent external audit than is normally required of public companies (eg six monthly or quarterly);
- a requirement that particular prudential disclosures are audited (in addition to the usual financial disclosures) – eg capital adequacy, exposure concentration, connected lending, market risk disclosures, etc;
- a requirement that a bank's risk management systems are periodically subject to external audit or some other external review, sometimes under the overview of the supervisory authority;
- a requirement that the appointment of a bank's auditor is subject to the approval of the supervisory authority;
- a requirement that the bank periodically change its auditor, in order to reduce the risk of "auditor capture";
- a requirement for the auditor to report to, or meet with, the supervisory authority; and
- a requirement obliging the auditor to report any concerns they may have to the supervisory authority.

As a general rule, disclosures of financial information are more useful if they are made with a reasonable degree of frequency – eg six monthly or quarterly.

Disclosure of financial and risk-related information by banks should generally be in respect of the bank and the consolidated group. In some cases, holding company disclosures may also be appropriate.

As a general rule, banks could be expected to disclose:

- capital, disaggregated by type of capital, and the percentage of capital relative to credit exposures, using the Basel Capital Accord as the measurement framework or a credible alternative;
- the bank's credit rating and any recent changes to the rating. It may also be appropriate in some cases to require disclosure of the parent entity's credit rating and any recent changes to its rating;

- comprehensive and detailed information on the balance sheet, income statement and off-balance sheet obligations;
- exposure concentration, in terms of exposures to individual counterparties or groups of associated counterparties relative to the bank's capital;
- exposures to particular economic sectors or industries;
- detailed information on asset quality, including the amount of non-performing and restructured loans and the level of specific provisioning in relation to such loans. Disclosure requirements should desirably provide guidance on the basis upon which asset quality is reported and provisioning is determined;
- information on market risk (ie interest rate risk, exchange rate risk and equity risk), desirably using the Basel Committee's market risk methodology or a credible alternative;
- information on related party exposures;
- information on the nature of a bank's funds management, securitisation and other fiduciary business, including details of funding provided by the bank to these business activities and the structures in place to limit contagion between the funds management activities and the core business of the bank;
- information on the bank's systems for managing its business risks, including information on the nature of its internal control systems, internal audit arrangements and any other arrangements it has for an external review of the adequacy of its risk management systems and internal controls; and
- disclosure of the names, qualifications and experience of directors and senior management.

An important element of a well designed disclosure regime is the accountability it can bring to the board of directors. This recognises the vital role which bank directors play in overseeing, and taking ultimate responsibility for, the prudent management of all of their bank's business risks. In order to sharpen the accountability of a bank's directors, banks and other financial institutions could usefully be required regularly to disclose:

- the nature of any conflicts of interest that individual directors or senior managers may have;
- the board's rules for handling directors' and managers' conflicts of interests; and
- attestations signed by each director as to whether they are satisfied that the bank's risks are being adequately identified, monitored and controlled at all times.

For any disclosure regime to be effective, it must be enforced. Accordingly, there should be a competent authority charged with monitoring compliance with disclosure requirements and equipped with the powers to enforce compliance where appropriate. The authority should be subject to effective transparency and accountability structures.

There should be a prescribed set of penalties for non-compliance with disclosure requirements. Penalties for non-compliance should be clearly specified, and should apply not only to the financial institution itself, but also to its directors and other key officers. Penalties might include fines, imprisonment and civil liability (eg where directors or senior management may be held personally liable for creditors' losses where a bank fails, and creditors can establish that they had relied on disclosures issued by the bank and that these disclosures had been false or misleading).

In introducing a disclosure regime, it is also important to ensure that relevant audiences are well educated about the objectives of financial disclosure and the nature of the disclosure arrangements, so that they can make the most efficient use of financial disclosures. This might suggest providing explanatory material to financial journalists and analysts, and encouraging the financial news media to take a keen interest in the disclosures issued by banks and other financial institutions. And it might suggest the need for explanatory material to be provided to depositors, to assist them to interpret a bank's disclosures.

Strengthening market disciplines

It is increasingly being recognised that market disciplines play an important role in promoting financial system stability and in encouraging the maintenance of sound corporate governance and risk management practices. Banks are more likely to be attentive to risk management in an environment where poor risk management and financial performance are penalised by the market, and strong risk management and financial performance are rewarded by the market. In the longer term, robust market disciplines are likely to enhance financial stability and efficiency by strengthening the incentives for the efficient management of risks and by weeding out poor performers.

Unfortunately, various government policies and interventions have dulled the effectiveness of market disciplines in many countries. These can include:

- government ownership of banks and corporates;
- government guarantees of banks and corporates or implicit government support arrangements;
- poorly designed deposit insurance arrangements (particularly where the limits on deposit insurance are set at a high level and where banks are either not charged for deposit insurance or where the charges take little or no account of a bank's risk profile and risk management capacity);
- responding to bank failures in ways that insulate depositors and other creditors, and sometimes even shareholders, from losses;
- uncompetitive financial markets; and
- poorly developed capital markets.

In order to strengthen market disciplines on the financial system and corporate sector, and thereby encourage the development of sound corporate governance practices, a number of policy options can be considered.

One of the ways of strengthening market disciplines in the banking system is by privatising state-owned banks. The privatisation of government-owned financial institutions offers a number of potential benefits. These include: reduced fiscal risk associated with government ownership of financial institutions, strengthened market disciplines on the institution in question, sharper incentives for sound risk management within the institution and the likelihood of more effective shareholder surveillance of corporate governance and risk management structures.

Another option for reducing moral hazard risks and strengthening market disciplines on the financial and corporate sectors is to remove or limit government guarantees or implicit support arrangements for individual banks. As with privatisation, however, the removal of government guarantees needs to occur at a time when the banking system is in a sound condition and when structures have been bedded down to promote robust risk management. Once this has been achieved, the removal of government guarantees and minimisation of implicit support arrangements will assist in sharpening the disciplines on the banking system and thereby encourage the maintenance of effective governance arrangements.

A further ingredient in promoting sound corporate governance via market disciplines is to encourage competitiveness within the financial sector, by increasing the contestability and competitiveness of financial markets. This can be done both by opening up the financial system to new participants (both domestic and overseas) and by promoting a competitively neutral regulatory framework, so that the "playing field" is relatively level. In particular, opening up the financial sector to foreign banks can assist in promoting a more competitive, innovative and mature financial sector and can enhance the development of a more robust corporate governance and risk management culture in the financial sector. International banks of high quality can bring an infusion of skills and experience in corporate governance and risk management, encouraging existing market participants to adopt improvements in their own systems.

However, it is important to ensure that liberalisation of the financial sector is accompanied by other measures to strengthen the financial system, so that increased competitiveness does not result in instability. For example, prior to opening up the banking system to new banks, it is essential to ensure that the banking system is subject to high quality disclosure and corporate governance requirements, effective banking supervision arrangements and other structures to promote effective risk management. It is also essential that the liberalisation process occurs in the context of a stable economic environment, where economic policies are effective in minimising asset price volatility, where there are few regulatory distortions to relative prices, and where macroeconomic policy settings are sustainable and credible.

As noted above, inappropriately designed financial safety nets, including deposit insurance arrangements, can reduce the effectiveness of market disciplines on the banking system and reduce the incentives for effective corporate governance and risk management. This is particularly the case where financial safety nets are open-ended (with no cap on the amount of insurance) and risks are not adequately factored into the pricing of deposit insurance. An important challenge for governments is therefore to structure financial safety nets in ways that minimise moral hazard and strengthen market disciplines on financial institutions, while still ensuring that financial distress situations are effectively resolved.

It is equally important that, in responding to bank failures, central banks and regulatory agencies try to preserve disciplines on the failed bank, and its shareholders and creditors, so as to reinforce the incentives for sound corporate governance in survivor banks. This suggests the need to ensure that shareholders and subordinated creditors of the failed bank bear the full extent of losses attributable to them (rather than being "bailed out" by the government). To the extent practicable, it also suggests that there is benefit in ensuring that depositors and other senior unsecured creditors of a failed bank bear their fair share of losses.

Capital markets also have an important part to play in promoting sound corporate governance in the banking sector. Well developed equity and debt markets are likely to encourage the development of sound corporate governance and risk management practices through a number of channels. One such channel is through the imposition of stock exchange listing rules on market participants, including requirements relating to corporate governance and financial disclosure. These can assist in encouraging banks and other market participants to adopt and maintain high standards in their corporate governance arrangements.

Equity and debt markets also provide investors with a structured means of obtaining information on banks, making them better informed about the quality of banks' risk management and business strategies. In turn, this enables investors to reward well managed companies with relatively inexpensive pricing in the debt and equity markets, and to penalise poorly managed companies with higher pricing (and, in the extreme, cutting off a company's access to market funding). Therefore, an important means of encouraging sound corporate governance and risk management practices in the banking and corporate sectors is to encourage the development of efficient capital markets.

Prudential regulation and supervision

Prudential supervision can also play an important role in encouraging the adoption of sound corporate governance arrangements in the banking sector. There are various ways this can be done, and the appropriate method will vary depending on, among other matters, the extent of market disciplines operating in the economy and financial system. Options can include requiring bank directors to review and attest to the adequacy of governance and risk management systems, requiring banks to maintain effective internal audit arrangements, and requiring a minimum number of non-executive and independent directors on the boards of banks. Some supervisors go further and directly review banks' corporate governance arrangements and/or require a bank's external auditors to review the corporate governance structures in the bank. Another option is for the supervisory authority to issue guidelines to banks on corporate governance arrangements and risk management systems, where the guidelines can sometimes be used as a framework for periodic assessments of the adequacy of a bank's corporate governance arrangements.

Although there may be circumstances where a supervisory authority needs to play an active role in encouraging banks to adopt robust corporate governance arrangements, particularly where there may be little infrastructure and market discipline to encourage sound governance practices, there are risks in the supervisory authority becoming too closely involved. It is important that the supervisory authority makes a clear distinction between its role and that of a bank's directors and senior management. The function of the supervisory authority is to promote structures to encourage banks to maintain sound corporate governance arrangements; it does not have responsibility for implementing and maintaining governance structures or for managing risks – these are the responsibilities of the bank's directors and senior management.

Leading by example

An important element in promoting sound corporate governance in the banking sector is through "leadership by example" within central government and regulatory agencies. The adoption of robust corporate governance practices in the banking system is likely to be greater where central government and the regulatory agencies responsible for the financial sector lead the way by maintaining effective governance, transparency and accountability arrangements within their own operations. This suggests the need for government, government agencies and regulatory bodies to be subject to (among other matters):

- transparent arrangements that require appointees to government agencies to be suitably qualified and experienced, such that they have the ability to perform their duties effectively;
- transparent and rigorous internal governance requirements, including measures to promote effective risk management, internal audit, and management of conflicts of interest;
- appropriate financial disclosure requirements, based on professional accounting standards;
- effective external audit requirements, where the audit arrangements comply with standard professional auditing principles; and
- an effective accountability framework, requiring disclosure of public policy objectives; clear assignment of responsibility and powers for the fulfilment of objectives; disclosure of performance; disclosure of remuneration arrangements; a structure for facilitating external monitoring of performance; and credible mechanisms for removing officials for non-performance.

The importance of central government and its agencies being subject to effective corporate governance, transparency and accountability arrangements is being increasingly recognised. The IMF and World Bank are encouraging the adoption and maintenance of sound public sector agency governance and accountability frameworks through various measures, including technical assistance programmes, seminars, and the Financial Sector Assessment Programme. As part of this process, the IMF has released two public policy transparency standards: the Code of Good Practices on Transparency in Monetary and Financial Policies and the Code of Good Practices on Fiscal Transparency. Both of these standards set out general principles on the transparency of monetary, fiscal and financial regulation policies, encouraging the clear articulation of policy objectives, policy arrangements and performance. The code relating to monetary and financial policy also sets out basic principles for the governance and accountability of the agencies responsible for monetary policy and financial sector regulation.

4 Corporate governance in the banking sector – New Zealand's approach

This section briefly summarises the approach taken by the Reserve Bank to the promotion of sound corporate governance in the New Zealand financial system.

Promoting sound corporate governance in registered banks

A fundamental component of New Zealand's approach to the promotion of financial stability is the emphasis it places on the importance of corporate governance as a means of encouraging banks to effectively identify, monitor and manage their business risks. This approach recognises the critical role which directors have in overseeing the stewardship of their bank and in ensuring that the bank has a high quality management team and effective systems for managing risks.

Reflecting the importance attached to corporate governance, the banking supervision arrangements in New Zealand contain a number of policies designed to encourage sound corporate governance in the banking sector. These policies include:

- Comprehensive disclosure requirements for banks. All banks in New Zealand are required to publish comprehensive financial and risk-related disclosures on a quarterly basis, including information on a bank's:
  - capital position, measured using the Basel Capital Accord;
  - concentration of credit exposures to individual

counterparties;

- related party exposures;
- asset quality and provisioning;
- interest rate, exchange rate and equity risks;
- off-balance sheet exposures; and
- fiduciary risks.

- Director attestations. Each bank disclosure statement is required to contain a number of attestations, signed by each director. These are intended to encourage directors to focus their attention on key risks within their bank and to be satisfied that these risks are being effectively managed. Directors are required to attest as to whether:
  - the bank has systems in place to monitor and control adequately the banking group's material risks, including credit risk, exposure concentration risk, interest rate risk, currency risk, equity risk, liquidity risk and other business risks, and whether those systems are being properly applied at all times;
  - all prudential requirements applicable to the bank in question are being complied with (such as requirements relating to minimum capital adequacy and exposures to related parties); and
  - exposures to related parties are in the best interests of the banking group.
- Conflicts of interest. Banks are required to disclose directors' conflicts of interest and the policies in place for dealing with conflicts.
- Directors' responsibility and liability. Each bank director is required to sign the bank's disclosure statement and certify that disclosures made are not false or misleading. If a disclosure statement is found to be false or misleading, directors are subject to potentially severe legal penalties, including substantial fines and imprisonment. In addition, directors may face unlimited personal liability for creditors' losses where creditors relied on a bank's disclosure statement that was false or misleading.
- Composition of the board. Banks incorporated in New Zealand are required to have a minimum of two independent directors (who must also be independent of any parent company or other related parties) and a non-executive chairperson. These requirements are intended to increase the board's capacity to exercise appropriate scrutiny over the performance of the management team. In addition, independent directors provide some assurance that the bank's dealings with its parent or other related parties are not in conflict with the interests of the bank in New Zealand.

The requirements imposed on bank directors complement and reinforce the standard duties applicable to company directors generally, as contained in the New Zealand Companies Act. This Act imposes a number of duties on directors, including a duty:

- not to allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors;
- not to allow the company to incur an obligation unless the director believes, on reasonable grounds, that the company will be able to perform the obligation when it is required to do so; and
- to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances.

Complementing these requirements, New Zealand's approach to financial sector regulation also seeks to promote sound corporate governance in the financial sector by creating an environment conducive to robust market disciplines. This is achieved through a number of measures, including the promotion of a relatively open banking sector, a competitively neutral approach to regulation (enabling banks and non-banks to compete on largely equal terms), and the absence of deposit insurance. In addition, the Reserve Bank's approach to responding to a bank failure stresses the avoidance of a government-funded bail-out of the bank in question, and seeks to ensure that shareholders, subordinated creditors and senior creditors (including depositors) bear their fair share of losses.

Leading by example – corporate governance in the Reserve Bank

In addition to the measures taken to promote sound corporate governance in the commercial banking sector, the

Reserve Bank is also subject to a number of policies designed to promote a strong governance framework within the Bank. These include:

- A clear, publicly disclosed set of policy objectives and associated responsibilities. These are set out in the Reserve Bank of New Zealand Act 1989 and (in the case of the Bank's monetary policy objectives) in the Policy Targets Agreement between the Minister of Finance and Governor of the Reserve Bank. In addition, the Bank has issued numerous publications, aimed at different audiences, explaining its policy objectives in each of its core functions and the means by which the Bank seeks to achieve those objectives.
- A clear, publicly disclosed set of duties and accountabilities for the Governor. Again, these are specified in the Reserve Bank Act and in the Policy Targets Agreement.
- Clear specification of the role and duties of the Reserve Bank's board of directors. The Act specifies that the Board's principal responsibility is to monitor the performance of the Governor and the Bank in meeting the Bank's objectives. The Board also has the authority to give advice to the Governor and is empowered to recommend to the Minister of Finance that the Governor be dismissed in specified circumstances. A further responsibility of the Board's non-executive directors is to periodically recommend to the Minister of Finance the appointment (or reappointment) of the Governor. The Minister is not bound by the Board's recommendation, but is not able to appoint a person to the office of Governor without a recommendation from the Board.
- An obligation to report publicly, on a regular basis, on the Reserve Bank's performance in meeting its statutory objectives (particularly the achievement of price stability). The Bank does this in various forms, including in its *Monetary Policy Statements* (currently issued quarterly) and in its *Annual Report*. In addition, the Governor and other senior staff appear before Parliament's Finance and Expenditure Committee on several occasions during the year to respond to questions relating to the Bank's performance. Various publications issued by the Bank, including the *Bulletin*, also provide information on the Bank's assessment of its performance and provide an opportunity for public scrutiny of its effectiveness in carrying out its functions.
- Clear disclosure of all regulatory requirements and policies promulgated by the Reserve Bank. The Bank is statutorily obliged to issue a *Statement of Principles*, setting out its approach to the registration and supervision of banks. This is publicly available, including on the Bank's web site. In addition, the Bank publicly discloses all banking supervision regulations, including the disclosure regulations applicable to registered banks.
- An obligation to issue an annual report and set of financial statements, independently audited, that comply with New Zealand's accounting standards and practices, including information on accounting policies, off-balance sheet commitments and contingent liabilities.
- A culture of comprehensive planning and budgeting, and internal and external accountability for expenditure and performance. The Bank also maintains comprehensive risk management and internal audit arrangements, including a risk-assessment unit with responsibility for assessing the full range of risks within the Bank.
- An obligation for the Bank's Governor and Deputy Chief Executive to sign publicly disclosed statements attesting to the maintenance of internal controls to promote the integrity and reliability of financial reporting.
- The Minister of Finance is empowered to appoint a person to audit the performance of the central bank in carrying out its functions.

Taken together, these requirements provide a robust framework for encouraging effective corporate governance and risk management in the Reserve Bank.

As a result of the independent review of monetary policy, conducted in late 2000/early 2001, some additional measures are being implemented to further strengthen the Bank's corporate governance. In particular, the Reserve Bank Act will be amended to provide for a non-executive chairman of the Bank's Board and for the removal of the Deputy Governor(s) from the Board. In addition, the Act will require the non-executive directors of the Board (ie all of the directors other than the Governor) to issue a publicly disclosed annual report on their assessment of the Governor's and Bank's performance of the Bank's functions. In anticipation of this requirement, the Non-Executive Directors' Committee of the Board issued its first annual report in 2001, contained in the Bank's *Annual Report*.

In addition to these changes, the Bank has independently taken other initiatives to strengthen its governance arrangements in the last year or so in connection with its conduct of monetary policy. It has adopted a regular practice of engaging foreign monetary policy experts (usually from other central banks) to participate in the monetary policy decision-making process to provide a basis for peer review. This has proved to be a very effective way of seeking to ensure that the Bank's conduct of monetary policy is consistent with relevant international best practice and exposes the Governor and other senior staff to fresh perspectives from well seasoned monetary policy decision-makers.

The Bank has also appointed two external experts to participate in the monetary policy decision-making process on a regular basis. This provides the Governor with additional sources of advice to supplement the advice from staff and is another important mechanism for enhancing the Bank's decision-making and governance practices.

5 Conclusion

This article has argued that effective corporate governance and risk management practices are essential for the promotion of financial stability. The paper has identified a number of ways in which sound corporate governance and risk management practices in the banking system can be encouraged, including:

- the development of effective corporate law and the legal infrastructure to enforce it;
- measures to promote a corporate governance culture, including through the development of corporate governance principles;
- promoting high quality accounting and auditing standards, including effective enforcement of disclosure requirements, with an emphasis on holding directors to account for the truth and fairness of disclosures issued by their bank;
- policies to strengthen the market disciplines on the banking system, including through the nature of bank ownership structures, opening up banking systems to reputable overseas banks and introducing competition to the financial system; and
- effective supervisory techniques to encourage the adoption and maintenance of sound corporate governance and risk management practices.

The article has also noted the importance of government agencies, including central banks, leading by example through the adoption of their own sound internal governance arrangements.