The Role of Central Banks in Defining Corporate Governance in Banks

I wish initially to express my earnest appreciation to H.E. Riyad Salama, Governor of the Central Bank of Lebanon, the sponsor of this conference, and to Ms. Nahla Namli, Editor-in-Chief of the Al-Bank wal-Mostasmer magazine, for inviting me to participate in this conference, which is held jointly by the Central Bank of Lebanon and the Al-Bank wal-Mostasmer magazine. It also pleases me to address today this honorable audience of the conference on “Corporate Governance for Modern Banking Performance”. Furthermore, I wish to commend the choice of corporate governance as the conference theme, since this subject has achieved such prominence in the banking industry nowadays that the twenty-first century is being referred to as “The Century of Corporate Governance”.

Good corporate governance has gained in significance following the substantial changes in the private sector’s role in economic development, and the increased awareness of the important role of companies in the economy, as the practice of separating ownership from management in modern shareholding companies has become more widespread.

In the last few years, this subject has topped the agenda of economic authorities in various countries, as a result of crises which have befallen major shareholding companies, shedding doubt on the credibility of their management and the authenticity of their posted financial results, and leading to other financial and economic repercussions. The collapse of the Enron energy company stands as a prominent example of these crises, that company's bankruptcy being considered the biggest in corporate history.

As we know, good governance in banks is a subject of specific nature which owes its significance to the role of banks in the economy, and the substantial risks and negative consequences associated with improper banking practices. Good governance in banks is highly important, as banking work is very complex and supervisory authorities cannot single-handedly supervise banking risks. Additionally, it is impossible for banking rules and regulations to respond to each financial innovation. Consequently, the safety and soundness of banks require intervention and action on the part of shareholders and their representatives on the boards of directors. In this regard, Basel's paper on the enhancement of corporate governance in banking institutions indicates that supervision cannot operate efficiently in the absence of good governance. In the same view, Alan Greenspan pointed out the importance of good governance: "We need to adopt policies that promote counterparty supervision as the first line of defense for a safe and sound banking system".

Good governance is vital to the existence and success of any institution in the long run. In this regard, Jonathan

Charkham*, a specialist in corporate governance, says "Good governance is essential for the long-term success of an institution and depends greatly on the skills, experience and knowledge of its directors". This calls on banks' board members to commit to continuously developing their skills, and to making sure that corporate directors have adequate qualifications and experience, and constantly keep abreast of advances in banking work and financial and accountancy techniques. This emphasizes the formidable personal responsibilities associated with board membership in financial institutions.

Good governance in banks derives its importance from the nature of the role which legislation assigns to banks, enabling them to influence money supply, so that bank liabilities can become high-powered money. This means that the exposure of bank solvency and financial positions to risks, as a result of unsound banking practices, may result in loss of depositors' confidence and disruption of payment system mechanisms in the economy. Maintaining trust in the banking and financial system, along with firmly maintaining the strength of that system and the soundness of its institutions, has been the highest priority of central banks, particularly as banks represent the link through which monetary policy measures lead to final monetary policy objectives. This is part of the central bank's core objectives.

* Jonathan Charkam, a specialist in corporate governance, authored the book Guidance for the Directors of Banks, published by the Global Corporate Governance Forum, which was jointly established by the World Bank and the Organization for Economic Co-operation and Development (OECD).

Before illustrating the role of the Central Bank of Kuwait (CBK) and its experience in ensuring good governance in bank management and reinforcing good governance principles in financial institutions, I deem it appropriate to briefly highlight what is good corporate governance, its objectives and its basic elements.

Good corporate governance can be briefly defined as that system through which the performance of institutions is guided and supervised so as to achieve the required objectives. Furthermore, the purpose of good governance is to build up and reinforce accountability, credibility, and transparency, along with the integrity of data and information, so as to protect shareholders, employees, customers, the public and the supervisors.

In light of this definition and these objectives, the main elements of good governance are represented in the presence of a board of directors that has the qualifications and experience required for fulfilling its duties without any influence, laying down strategic plans and objectives, establishing a corporate value system, defining clear lines of responsibility and accountability, setting forth effective control systems backed by qualified and independent internal audit, applying compensation systems that provide incentives for the attainment of the institution's objectives, and practicing extremely transparent management.

Central banks play an important role in defining and reinforcing the principles of good governance in banks. The role played by supervisory authorities in this regard can be summarized as follows:

* Supporting the issuance of legislation and systems which would remedy the gaps and insufficiencies in legislation of relevance to good governance, whether at the level of legislation governing banks as companies, or legislation governing their work as banks.

* Encouraging sound practices in banks, ensuring that they have adequate organizational structures, and that their boards of directors and executive functions have practical plans for handling their responsibilities, and possess adequate qualifications and experience in banking and financial activities.

* Emphasizing the responsibility of boards of directors for any problems faced by banks, as well as for taking necessary action to remedy any gaps or infringements related to the work of these banks in a timely fashion.

* Being aware of any signs or indicators of weakness or faults in the management of these banks.

* Enhancing cooperation between those in charge of managing banks and the supervisory authorities.

* Continuously endeavoring to improve the regulatory and supervisory environment so as to foster competition among banking system units, noting that competition is an important factor in encouraging banks to adopt and apply the principles of good governance. This direction encompasses two highly important issues that were addressed in the Basel Committee's paper on the Core Principles of Effective Supervision. The first of these issues concerns the necessity for supervisory authorities to ensure that government-owned

commercial banks operate at the same high level of technical ability and effectiveness of regulations as private banks, since government support does not present government-owned banks with sufficient incentives to apply the principles of good governance. Hence, market discipline would become less efficient should market participants realize that government-owned banks are supported by the government and have easier access to money than is the case for private banks. The second issue concerns refraining from applying high-coverage deposit guarantees, so as not to weaken market discipline.

Kuwaiti legislation, and the regulatory and supervisory authorities in the State of Kuwait, have pursued the establishment of an enabling environment for good governance in Kuwaiti companies in general. Yet, the best practices in that area still require the continuous development of laws and regulations to confront any possible negative aspects in management practices. As for banks and financial institutions subject to the supervision of the CBK, the Central Bank of Kuwait has taken the initiative - since the early nineties - to issue and update instructions to banks in regard to good governance, in line with relevant international control standards and advances in banking work. Added to this is the fact that banks and financial institutions are governed by the laws and regulations applicable to Kuwaiti companies.

In light of the above, I wish to briefly highlight the main elements of good governance covered in our instructions to banks, particularly with regard to internal control and auditing, standards for board membership and definitions of members' responsibilities, disclosure and transparency, and observance and protection of rights of shareholders and third parties dealing with these banks.

First- Regarding internal control and auditing, the instructions issued to banks clearly emphasize the significance of internal control systems as an important foundation of good governance, given that current international recommendations for improved corporate governance are in essence concentrated on the necessity for strengthening internal controls. In this area, the CBK has issued a manual setting the general guidelines for internal control systems and the auditors' reports for the valuation thereof, along with guidelines on the principles of good governance. These guidelines cover the responsibilities of boards of directors in regard to setting up adequate internal control systems and entrusting an external audit bureau with assessing the adequacy thereof. The resulting reports are received and reviewed by the CBK, which makes sure that banks remedy any insufficiencies in their internal control systems.

We have also issued instructions to banks directing them to refrain from entrusting the assessment of the adequacy of their internal control systems or any technical or advisory tasks of an auditing nature to the external auditor which performs audit work for the bank.

Second- Based on the fact that effective internal control systems in banks and financial institutions must be supported by an effective internal auditing function that assesses the effectiveness and adequacy of these systems, the instructions and directives issued to banks emphasize the board's responsibility in ascertaining that the internal audit function is independent and qualified, that the scope and periodicity of audit correspond to the level of risks faced by the bank's various activities, and that the board appoints the chief and staff of the internal audit function and defines their prerogatives in line with the principles of independence and adequacy of audit. Worth noting is that the appointment of internal auditors requires the CBK's prior approval. In confirmation of the CBK's directives regarding support of the internalcontrol function in banks, the outsourcing of that function is not encouraged. In exceptional cases, the CBK's approval is obtained for the outsourcing of certain activities conducted for specified periods, on the condition that the outsourced activity is supervised by the internal audit function and the members of the bank's Higher Auditing Committee.

Third - Regarding setting the standards for board membership and determining the responsibilities of board members, and in light of the importance of that matter, we have decided that these standards and responsibilities shall be defined according to legislative provisions encompassed in the CBK Law.

In this regard, according to Article 68 of the CBK Law, nomination to board membership and to the positions of chief of executive staff, and deputies and assistants thereof, requires the CBK's prior approval, which is based on adherence to the provisions of the Law for board membership, and the fulfillment of the rules and regulations issued by the CBK Board regarding the requirements of appropriate educational qualifications and adequate banking and financial experience for nomination to such positions. In issuing these regulations, due consideration has been granted to the application of the principles of good governance in banks by defining the requirement of university qualifications and adequate experience in the banking, finance and economic areas. Furthermore, since independence of action is considered an element of good governance according to current practice, the position of chairman of the bank board has been separated from that of the chief of executive staff. In turn, the instructions and directives issued by the CBK in regard to good governance also confirm the importance of that disposition and cover subjects such as the formation of an auditing committee made up of board members who do not perform executive functions in the institution, along with ensuring that there is no overlapping of jurisdiction between the board and the executive management, and that the board is not under any influence from inside or outside the institution. Also, our directives to banks in this regard provide that the board shall draw on the executive staff for the implementation of the board's decisions, though without intervening in the executive staff duties. Should a member of the board participate in the implementation of a board decision, such participation shall be by delegation from the board, along with advising the board on what has taken place in this regard.

Fourth - Regarding the board's responsibilities, the instructions and directives issued in this regard encompass the determination of the board's responsibility in laying down strategic plans and objectives, setting up the bank's organizational structure and internal control function, establishing risk management and follow-up systems, and exercising effective supervision over the executive staff. Additionally, these instructions and directives define the board's responsibility towards the bank, its shareholders, and the supervisory authority, the application of sound professional practices, the management of conflicts of interest, the adequacy and transparency of data available to the shareholders and the public, financial compensation packages, etc.

Fifth - With regard to defining the role and responsibilities of the executive function, these directives encompass the definition of the executive's responsibility towards proposing work strategies, plans and policies for the institution's banking and financial operations, executing the board's endorsed policies, and providing the board with periodic financial reports on the application of policies, the institution's activities and the results of operations. The executive staff shall maintain transparency and objectivity in their reports, and ensure that the institution abides by the laws, regulations and instructions applicable to its activities, so as to avoid the risks of non-compliancy, including risks to reputation and legal risks. Additionally, the executive staff shall ensure that activities are carried out in compliance with the standards of professional ethics, and formulate appropriate instructions to be followed by all staff in the institution, with regard to the strengthening and development of values.

Sixth- With regard to enhancing the effectiveness of the board's supervision over the bank's activities, the directives issued to banks emphasize the need to set up an auditing committee - reporting to the board - whose members shall be elected by the board from among those board members not involved in executive functions, and possessing adequate financial experience in the review and analysis of financial statements. The directives highlight the committee's functions with regard to overseeing external auditing, reviewing the comprehensiveness of audit, coordinating the external auditors' work, overseeing internal audit, reviewing the adequacy and effectiveness of internal control, including the review of policies and procedures concerning sound practices for the management and surveillance of various risks, and ensuring compliance with policies and laws. The directives also encompass the periodicity of committee meetings, the participation of the head of internal audit in these meetings, and the writing of minutes of these meetings as part of the bank's records.

Furthermore, the directives recommend that the banks consider setting up a number of other committees, such as a compensation committee, to determine bonuses and compensation in line with the interest of the institution and shareholders. The formation of these committees is in keeping with the requirement to enhance internal control measures, improve the board's supervision of bank operations, increase the protection of bank assets and property, and achieve optimal use of the bank's financial resources.

In accordance with the Commercial Companies Law, and the CBK's instructions, each bank shall - in its capacity as a listed company - have two external auditors, noting that the appointment of external auditors requires prior approval of the CBK.

Seventh- With regard to disclosure and transparency, our directives to banks and investment companies require that their management structure and policy encompass an adequate mechanism for the timely disclosure, to the shareholders and the public, of all important information on the institution. These directives also encompass the importance of proper disclosure as a pivotal element in the follow-up by the market of the companies' performance and management efficiency, including the exercise of voting rights by shareholders. The directives also note the importance of effective disclosure for allowing market participants to realize the risks confronting the bank, along with providing examples of information and data which represent minimum disclosure requirements.

Furthermore, according to the CBK's instructions, banks are obligated to prepare and disclose their financial data according to the International Accounting Standards, and publish them in a form that makes them accessible to users in a timely fashion.

Eighth - The directives issued to banks highlight the importance for their management structure and policies to reflect the principles of good governance with regard to protecting shareholders' rights, dealing with them all - including small and foreign shareholders - equitably, allowing shareholders to hold the board of directors accountable for remedying any violation of their rights, and respecting and protecting the rights and interests of parties connected to the institution, such as employees, depositors, borrowers and customers, thereby entitling these parties to demand redress of any violation of their rights, according to the provisions of the laws and regulations.

Ninth – The CBK has issued another group of instructions and directives concerning the principles of good governance in banks and financial institutions. Most important among these instructions are those concerning the application of sound practices in the management and assessment of operating risks in banks, according to Basel principles, the instructions requiring banks to set up systems on a scientific and practical basis for measuring and managing risks associated with their various areas of activity, the instructions for combating money-laundering and financing of terrorism, along with a group of instructions concerning the various aspects of rationalizing credit and investment policies.

Worth noting is that the CBK Law and the group of instructions and directives issued by the CBK in the area of banking supervision, including those concerning the principles of good governance, have been translated into English and are posted on the CBK's website. Worth noting also is that the CBK regularly publishes on this website newly issued instructions, directives, and any update or modification of existing instructions.

I hope that this conference will contribute to realizing our aspirations in regard to strengthening the principles of good governance in banks and other companies in general, and thereby achieve the objectives for which it is being held. In closing, I wish to emphasize that the main basis of good governance lies in developing the values and professional ethics of corporate managers and staff alike, along with endeavoring to firmly establish these concepts through a new culture that will pervade every aspect of our life. Undoubtedly, this calls for introducing comprehensive changes to the customs, culture and concepts which have emerged and accumulated over years of practice.