1 Feature Article

Better Boards - The Path Towards Stronger Corporate Governance in Financial Institutions

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HIGHLIGHTS

- Boards of financial institutions are responsible for ensuring all decisions and actions made are in the best interest of the financial institutions, depositors and insurance policyholders.
- The boards set the right 'tone from the top' to reinforce ethical, prudent and professional behaviour.
- The changing financial landscape coupled with growing focus on social responsibility and stakeholders' activism will continue to change the role of boards.
- Boards must keep pace and continue to steer the financial institutions with impeccable integrity and conduct.

Sound corporate governance - the key to institutional soundness leading to financial stability and sustainable economic growth

Unlike other companies, a banking institution performs the role of facilitating the functions of the economy by intermediating funds to support the real economy. Likewise, insurers and takaful operators provide safety nets to individuals to reduce their hardship following loss events such as accidents and natural disasters. Underpinned by these factors, a sound corporate governance standard in financial institutions is important to ensure that intermediation activities are conducted effectively and responsibly, while all obligations are met on a timely basis. Sound corporate governance standards must be institutionalised and become a way of life in the organisational context of a financial institution. Ultimately, the realisation of these expectations lies with the boards of financial institutions.

Past global financial crises show that among the key contributing factors to financial losses suffered by financial institutions and consumers were ineffective boards that exercised inadequate oversight on executive and senior management who are responsible and accountable for the soundness of the financial institutions' day-to-day management activities. These significant losses caused erosion in public confidence, disruption in financial markets and in some cases, destabilisation within the wider economy. Learning from these costly and painful episodes, regulators in advanced economies and many others across the globe have cast their focus and attention on the strengthening of financial institutions' corporate governance standards.

In Malaysia, the Bank's efforts to improve financial institutions' corporate governance standards were first directed towards enhancing the governance arrangements at the board level, strengthening board evaluation policies and practices and complemented by continuous training programmes to ensure the boards are effective in providing stewardship, oversight and direction. The Bank also saw the need to hard code the boards' fiduciary duties into law so as to elevate and give prominence to the role of directors in tandem with their growing accountability and responsibility. The duties and responsibilities of the boards and directors have therefore been codified into the Financial Services Act 2013 and Islamic Financial Services Act 2013.

Regulatory framework provides conducive environment for boards to perform their roles effectively

(i) Stronger independence and improved board competency profile

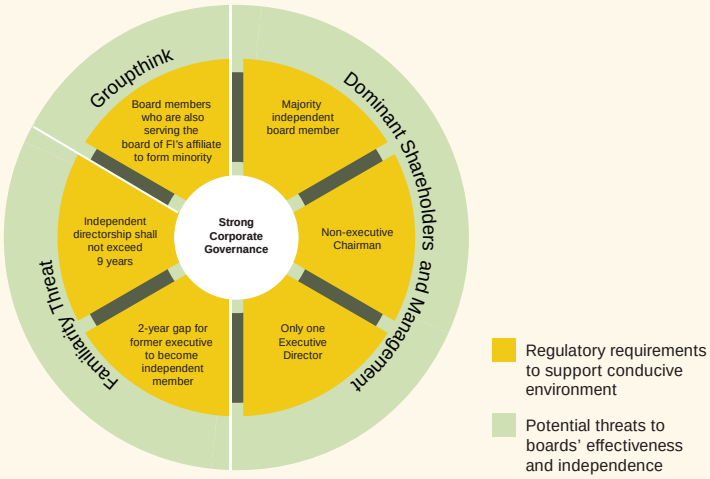
Since the Asian Financial Crisis 1997/1998, boards' independence and composition in terms of size, diversity and skills have improved significantly. To ensure robust checks and balances, the number of independent directors required on the boards of financial institutions was initially increased to one-third and more recently to form a majority of the board. These requirements have since been complied with underlining the industry's recognition of the importance of board independence from elements of excessive influence that may be exerted by significant shareholders and dominant management.

As financial institutions become larger and more complex, the boards must have the requisite skills and capacity to assess material risks and emerging developments affecting the business and operating environment. This entails the need for boards to have a diverse set of skills, experience and competencies to identify and deliberate on current and emerging risks as well as challenges faced by financial institutions. Today, boards of financial institutions have evolved into having members with diverse skill sets including in areas such as risk management, accounting, law, human capital, information technology, Islamic finance and Shariah. Financial institutions with regional presence have also appointed board members with regional exposure to better manage inherent risks related to cross border business. The increasing diversity in skills and background have also enhanced the boards' strategic and technical capabilities to meet the challenges associated with an environment of increasing uncertainty and complexity.

(ii) Clear separation of management and board

As part of the reforms made post crisis, the Bank has introduced a number of prudential measures to reduce the involvement and influence of management on the boards of financial institutions. A significant milestone was achieved when the Bank directed financial institutions to separate the roles of executive function from the chairman in 2005. Subsequently, the number of executive directors was restricted to a maximum of two in 2013 and further reduced to one in 2016. In addition, the definition of executive directors has been expanded to include any individual who has management responsibilities in the financial institution's affiliates[1]. A former executive of a financial institution must also serve a two-year cooling off period before being eligible as an independent director of the same institution. These developments represent a forward leap towards making boards' judgement and decision-making more independent of management influence and also lead towards more objective scrutiny of management's performance.

Chart 1: Regulatory requirements have created conducive environment for boards to effectively discharge their fiduciary duties



Source: Bank Negara Malaysia

[1] The definition for affiliates includes a corporation that controls, is controlled by, or is under common control with the financial institution.

(iii) Greater oversight over risk, internal controls, remuneration, succession planning, directors and senior management appointments and performance assessment

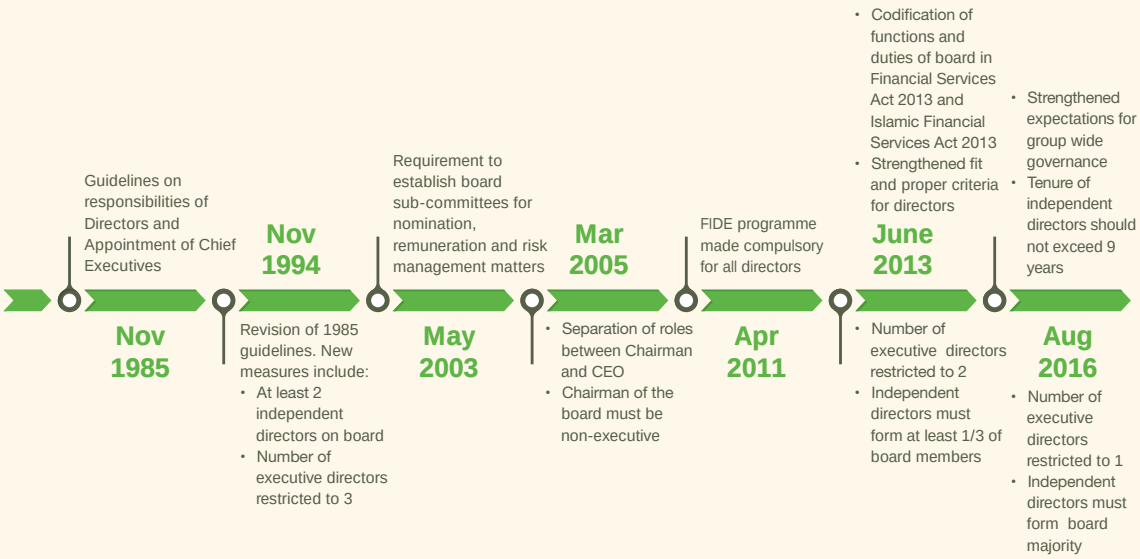
A sound board oversight structure is key to good governance. In line with the Bank's expectation, financial institutions have established dedicated board oversight functions through audit, risk management, nomination and remuneration committees. Some large financial institutions have also established other board committees to provide enhanced oversight on compliance and information technology, in tandem with the nature and complexity of their institutions.

Dedicated committees ensure key matters are given sufficient focus and in-depth deliberation to ensure informed decision-making. The empowerment to the dedicated committees enables the boards to sharpen their focus on strategic matters concerning the financial institutions. This structure also promotes efficient management of boards' resources.

(iv) Enhanced directors' competencies through on-going training regime

In order to be able to constructively challenge and guide the management team, boards must be in a position to understand and evaluate the risks emerging from the activities and operations of the financial institutions. Recognising this need, the Bank, together with the financial institutions have taken concerted measures to ensure that boards collectively possess the requisite experience and expertise to steer the financial institutions in the right direction. Financial institutions have established bespoke on-boarding programmes to further expose board members to the regulatory framework governing the financial institutions, as well as to expedite their institutional understanding. In addition, it has also been made compulsory for board members to complete the Financial Institution Directors' Education (FIDE) Programme[2]. Through such structured training programmes, directors have been given further exposure to deepen their understanding on boardroom governance, examine the interlinkages between risk dimensions and capital management, and explore key issues facing financial institutions in areas such as business strategy, risk management, succession planning and stakeholders' management.

Chart 2: Evolution of corporate governance standards has elevated the effectiveness of board stewardships in financial institutions



Source: Bank Negara Malaysia

[2] FIDE programme is jointly organised by Bank Negara Malaysia, Perbadanan Insurans Deposit Malaysia and The Iclif Leadership and Governance Centre.

Expectations on boards will continue to evolve along with changes in operating landscape and regulatory demands

It is imperative that board members of financial institutions uphold the highest level of integrity as boards set the tone and culture of an organisation. With the right tone and culture from the top, business dealings and decision-making will be guided by sound judgment and ethical values. Financial institutions with sound risk cultures are more likely to grow their business in a sustainable manner while observing greater standards of risk management and compliance to regulatory expectations.

The corporate governance standards of Malaysian financial institutions have been significantly enhanced over the years. Nevertheless, the evolution of sound corporate governance is far from over. In the era of innovation and digitalisation, the rising leverage of global financial services on information technology such as Big Data and cryptocurrency widens the range of risks facing financial institutions. In navigating this uncharted territory, higher expectations will be put upon the boards for their oversight of technology risk such as data management and cyber security. In this regard, financial institutions are expected to be proactive in prepping the boards with the required expertise.

The Bank is now accelerating efforts to elevate the level of professionalism, ethical standards and integrity of the financial industry. For instance, enforcement actions taken against financial institutions and intermediaries for non-compliance to rules and regulations will be published starting from January 2018. With greater repercussion and higher reputational risk at stake, matters such as compliance and risk management are expected to be given greater prominence by the boards. Regardless of the forces of change, the relentless pursuit of a strong corporate governance foundation by financial institutions remains; to protect the critical role of financial institutions in supporting the real economy and preserving financial stability.

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