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Corporate Governance : Towards preserving financial stability and sustainable growth

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Bismillahirrahmanirrahim

In this increasingly highly uncertain environment, management has become a key differentiating element in determining relative performance. For the financial sector, the Asian financial crisis in 1998 underscore the importance of maintaining financial stability as an enabling factor in achieving sustainable economic growth. This is even more evident in the context of a highly integrated global financial system where financial shocks are easily and rapidly transmitted across markets and to the domestic financial sector. The impact is particularly adverse and powerful if there is weakness in corporate governance. In Malaysia, the highest priority has been accorded to ensure financial stability. For emerging market economies, the challenge of achieving financial stability extends beyond the need for regulatory reform to the need to develop robust and efficient financial structures. The challenge to policy makers in this new environment is to preserve confidence and stability and to promote balanced and equitable growth. We have seen that financial restructuring efforts and measures to enhance corporate governance undertaken in the region has not only contributed to re-establishing and restoring confidence in the financial system, but has contributed to enhanced effectiveness and efficiency of the financial system.

In the Malaysian context, the financial and corporate sector restructuring, the consolidation process and other financial reforms that has been undertaken over the recent years have enhanced the strength and resilience of the banking system. The Bank Negara Malaysia Annual Report 2002 that has been released today indicates significant improvements in the strength and resilience of the banking system. The stronger balance sheet with the risk weighted capital ratio of 13% and the lower level of non-performing loans and provisioning have placed the banking institutions in a much stronger position to absorb shocks emanating from the current uncertain environment.

The long-term resilience of the banking system and the sustainability of economic growth with embedded self reinforcing elements of rising efficiency and productivity are however, critically dependent on building strong foundations of good corporate governance. While the progress in enhancing corporate governance has thus far been encouraging, the challenge of rapidly changing global and financial environment today demands more widespread and even higher standards of corporate governance than what we have achieved so far. In today's very challenging environment of heightened risks arising from globalisation, volatile and large financial flows and frequent tendencies for markets to overreact and for a prolonged period, strong corporate governance practices become the bulwark of risk mitigator and stability.

In addition, uncertainties arising from external developments including geopolitical

developments and their impact on the global economy and financial markets have made the need for sound management and strong corporate governance to be a core objective and target of corporates and financial institutions. Sustainable performance requires strong foundations to ride the economic cycle, ability to withstand unstable market conditions and overall adaptability to adjust to a rapidly changing environment. Decision-making would become more challenging and thus require the support of timely, reliable and transparent information as well as balanced processes for decision making. The need to consider the various forces of change has made it necessary for management to conduct in-depth analysis and adopt forward looking perspective that is able not only to manage short term targets but yet stay focus on the medium and long term strategic orientation and goals. We need to go beyond the bottom lines, and also focus on the broad range of factors that ensure long-term sustainable performance.

Ladies and Gentlemen,

It is my pleasure and indeed an honor to be invited to share with you my perspectives on "Corporate Governance". Corporate governance issues are indeed relevant given the series of corporate failures and the crisis of confidence over corporate excesses in both developed and developing countries. The accumulation of breakdowns in internal and external checks and balances and in the values of good governance and the narrowing of focus for personal gains at the expense of other stakeholders, have caused several large and high profile corporations to collapse under the weight of malpractice and frauds. The rising incidences of poor governance have resulted in the erosion of confidence among investors worldwide, raising the cost of capital, reduced access to financial markets and restrained the growth of productive initiatives and incurring high costs when public sector resources have to be utilized for bail out. These developments have resulted in a re-examination of the regulatory framework and the introduction of new and more demanding regulations. While these regulatory actions may serve to address the malpractices, a balance approach needs to be taken to ensure that its implementation will not have destabilising implications on the corporate sector. Here, the challenge is to strike a balance between Government regulation and self-regulation. My remarks this evening will focus specifically on the importance of corporate governance in the context of the financial sector, why it is critical in view of its profound impact on the financial stability and long-term sustainability of growth and dynamism of the economy.

Ladies and Gentlemen,

As the lynchpin of the economy, a well functioning and efficient banking system is vital for achieving robust and sustainable economic performance and thus improving the welfare and standards of living. In the context of a progressive and competitive economy, the banking institutions perform the very important function of efficiently channelling these savings for productive investments. In view of the special role that banking institutions have in the economy in performing the intermediation function of channelling funds between the savers and investors, high standards of integrity and governance in banking institutions is even more essential. The importance of sustaining confidence of depositors that entrust their funds to financial institutions cannot be compromised. While depositors need to be assured of the safety of their deposits, productive investment can only be self-reinforcing if the funds are efficiently allocated and

adequately reflect the opportunity cost of capital as well as the returns on investment.

Banking business involves risks and these risks need to be rigorously managed if public confidence in the banking system is to be preserved. These risks involve credit risk, market risks, sovereign risks and foreign exchange risks, to name a few. Because of the wide-impact on the whole economy, the business of banking is too important to be left to self-regulation. The regulatory framework that has been put in place is therefore a key part of the process to ensure the soundness and efficiency of the banking system while protecting the interest of depositors and investors.

However, while much can be done to enhance regulations, supervision and surveillance of the management of risks by the financial institutions, the final accountability and responsibility lies with the Board of Directors and senior management. The regulation of banking institutions therefore needs to be complemented and reinforced with strong internal corporate governance practices. In addition, the global experience has shown that not all banking failures were due to economic and financial crisis. Some banking failures were caused by the lack of good corporate governance. Lack of oversight, lack of transparency, weak internal controls, lack of check and balances, incompetent directors and abuse of power are among the elements of poor corporate governance. The best regulation and supervision and the best financial safety net would not prevent such banking failures. The regulation of banking institutions therefore needs to be complemented with good corporate governance. The special position financial institutions and the important role they play in the economy makes having good corporate governance framework even more vital. It is even more important than in the corporate sector given that most of the funds for their business belong to depositors. In addition, any failure of a banking institution affects not only the shareholders but could also have systemic implications on overall stability of the financial system.

In the context of the banking industry, corporate governance involves the manner in which the business and the affairs of the individual banking institutions are being governed by their board of directors and senior management, how the economic returns are generated to the owners and the consideration of the interests of recognised stakeholders including depositors' and how they behave in a safe and sound manner in compliance with applicable laws and regulations. In this context, the transparency in the conduct of banking institutions, facilitated by the proper accounting standards that reflect the true and fair value of banking operations would lead to greater accountability and responsibility on the part of the bank's management.

Corporate governance in the banking sector thus involves the range of practices covering proper conduct of business, values, ethics and the whole culture of organizational and staff behaviour. It not only involves process and financial targets to serve the interest of the shareholders but also best practices of conduct with depositors, customers and other stakeholders. While the board and senior management take responsibility of operational issues and financial targets, of equal importance is to provide sound leadership in dealing with all the stakeholders of the financial institutions. A progressive board and management will provide the leadership for financial institutions to grow, establish robust risk management policies and framework to absorb financial shocks and cyclical downturns.

Historical experience has shown that the lack of integrity, honesty, professionalism, poor controls and unhealthy assumption of risks are indeed the sure recipe for sub-optimal allocation of resources and the sub-performance of the economy.

Sustainable performance requires a re-examination of today's business models. In this more competitive environment the pressure of market to focus on short-term returns, no doubt have profound impact on banking business and the way it is run. Business models have tended to focus on shorter and shorter time horizons. The increasingly liberalized and globally integrated financial system and global market place have exposed Malaysian corporates to greater opportunities as well as risks. Similarly, advances and sophistication in information and communication technology would have direct impact on the relevance of existing business models, decision process and business execution in a rapidly changing world. All these developments have consequently imposed great expectations on the Board of Directors and senior management to provide the leadership and to balance judgment, but also to be forward looking in guiding the organization forward.

In today's business environment where competitiveness and sustainability is critical, a differentiating element that determine winners is not just having the value business propositions but also having the competent staff with right attitude and values, and perspectives. Of importance is the effective communication of the long-term aspirations and strategies to the staff and shareholders to contribute towards enhancing the strength of an organization for long-term growth. In the new environment, the focus of value creation has now moved from physical assets to intangibles. In the context of banking institutions in emerging economies, the development of a pool of best talents that provides the appropriate leadership and management skills for emerging market economies has to be accorded priority. In this regard, Bank Negara Malaysia has instituted measures for banking institutions to place emphasis on staff development and capacity-building to ensure the sustainability of performance of the banking institutions.

Ladies and Gentlemen,

Indeed, a strong culture of corporate governance goes beyond the independence and accountability of the board of directors and management, to the strengthening of regulatory enforcement. In many developed countries, there has been a significant reliance on self-policing and private disciplining measures in promoting good governance, particularly in the realm of accounting and audit practices. But questionable accounting practices and the major corporate failures that resulted have now raised serious questions on the need for more stringent regulatory oversight. The strategy in strengthening market discipline therefore requires a balance between prudential regulation, market discipline and shareholders' surveillance so as to promote long-term stability.

In a further endeavour to align boards of directors with shareholders, Bank Negara Malaysia is currently reviewing the corporate governance framework for banking institutions with the objective of placing greater emphasis on the role of independent directors, minimum qualifications of such directors and their compensation. In an environment where businesses would need to balance between the interests of various stakeholders, which could be conflicting at times, an appropriate framework for active checks and balance of governance is indeed crucial. In this

regard, the development of a competent set of independent directors would be a key factor. The challenge is in identifying outside directors who are sufficiently independent but knowledgeable to function as watchdogs for minority shareholders and other stakeholders. Independence reflects qualities of objectivity, experience, insight and force of character. The need for directors to possess this blend of knowledge and independence is critical, given the increased complexities of business activities and the rapid pace of changes in financial markets and practices. Getting the right balance of expertise and independence so that the board does not rubber-stamp the decisions of top management is indeed a major challenge.

Ladies and Gentlemen,

In Malaysia, the Government has been the main catalyst for corporate governance reform. Malaysia has essentially adopted a hybrid approach towards corporate governance reform that includes legal reform, self-regulation as well as undertaking measures to encourage market-based regulation. Malaysia has proceeded on the basis that there are aspects of corporate governance where statutory regulation is necessary and effective and others where self-regulation is more appropriate. The release of the Finance Committee Report on Corporate Governance in 1999 marked a new beginning of our concerted efforts towards enhancing the standards of corporate governance in Malaysia. It recognized that there is a crucial need to continue the process of building the necessary legal and institutional framework to support the development of good corporate governance practices within the capital and financial markets.

In this context, Bank Negara Malaysia has put in place measures to enhance the standards of corporate governance in the banking sector. The Banking and Financial Institutions Act 1989 provides the legal framework to amongst others protect the interest of shareholders, customers as well as provide the prudential framework to promote the stability of the financial system. Examples of the provisions in the Act include the maximum shareholding limit for individuals and corporations in banking institutions to avoid concentration of ownership. There is also restriction on extension of credit to related parties in order to avoid potential conflict of interest situation as well as setting up of limits on lending to a single customer. Other measures include the issuance of specific guidelines on the role and responsibilities of directors and the audit committee.

A Code of Conduct for Directors, Officers and Employees in Banking Industry has also been introduced to promote and maintain a uniform ethical standard so as to safeguard the integrity and credibility of the staff of the banking institutions. Minimum Internal Audit Standards with the aim to improve the quality of internal audit so as to provide the basis for guidance and measurement for performance of internal audit function and improve operational effectiveness of financial institutions, has also been put in place. The guideline also stipulates the main duties and responsibilities of internal auditors, scope of audit work, reporting and documentation of internal auditing as well highlighting the critical areas of operations which internal auditors should give due consideration. In addition to the above, to improve the level of transparency, minimum standards of disclosure in the financial statements has also been put in place and is continuously being reviewed to provide adequate and appropriate information on banking institution's risk profile, financial health and business performance to the public. The main objective of

these guidelines is to engender public confidence in banking institutions and to ensure that the management and board of directors exhibit integrity and professionalism in the running of the banking institutions.

Conclusion

The importance of sound corporate governance is clear. It is vital that all stakeholders, both public and private sector participants inculcate and instil a culture of good corporate behaviour. The responsibility for sound corporate governance must be a joint responsibility between the authorities, corporations, financial intermediaries, regulators and shareholders. While much effort has been made to put in place for a sound corporate governance framework, this alone would not suffice. The challenge here is in its application - to translate this into practice. For corporate governance to work, good corporate governance should be embedded in all aspects of the spectrum. Competition should not be seen as barrier to sharing knowledge and experience on issues of common interest for the betterment of the industry and economy at large. On that note I thank you for your attention.