The Challenges of Good Corporate Governance for Effective Risk-Based Banking Supervision

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I. Introduction

Corporate governance has changed tremendously over the past two decades. These changes have been driven by new laws, regulations, guidelines and rising investor and public expectations. In the past, many boards were under the thumb of their chief executive officers (CEOs); this is no longer the case. Today, boards generally strive to govern their companies by benchmarking a set of best practices which have emerged and codified in corporate governance laws, stock exchange listing rules and company annual reports. Many individual directors are willing to accept these additional responsibilities.

A major development in corporate governance in recent years is the increasing emphasis on independent directors on the boards of companies to ensure objectivity and avoid conflict of interest. The downside is that boards get stuffed with directors (mainly non-executive) who have little institutional knowledge of the company and its business. Directors' inadequate knowledge is often compounded by the quality of information from management, especially where it is excessive and poorly organized. Another handicap relates to vague unclear roles, duties and responsibilities. As a result, many boards carry on business as

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usual without much reflection on what they ought to be doing.

The financial crisis that hit the East Asian economies in the late 1990s and the collapse of a large number of high profile large US firms including Enron Corporation, Worldcom and Arthur Andersen have heightened interest in good governance practices. In both instances, lack of good corporate governance mechanisms leading to institutional weaknesses was blamed for the losses and resultant instability. The crises cast into bold relief the fact that risk factors inherent in banking need to be tackled head-on and that mechanisms to identify, measure and control risks are required to detect and correct potential problems early. Against this backdrop, corporate governance and risk-based bank supervision have come to be acknowledged as fundamental guiding principles for a stable and efficient banking/financial system.

The banking industry is changing with a dynamic world. It is increasingly characterized by a complexity of products and services, internationalization of financial services, mergers and acquisitions, a convergence of products and regulatory practices across the financial services sector. Yet, there is a growing pressure to increase the efficiency and effectiveness of the regulatory function. The supervisory response has been to move away from the beaten track of compliance supervision, compliance reviews and rule-based model toward risk-based supervision, focused reviews and reliance on work of other actors such as the board of directors and regulators.

II.0 Good Corporate Governance
Corporate governance is regarded generally as the set of structures, processes, principles and policies affecting the way an institution is directed, administered and controlled. It includes the relationships amongst the many stakeholders involved and the goals for which the institution is governed. The principal
stakeholders are shareholders, board of directors and management. Others include employees, suppliers, customers, regulators, environment, and the community at large.

II.1 Definitions
A number of definitions of corporate governance provided by writers and experts on the subject reveal clearly the issues involved. The definitions include the following:

a) The Code of Corporate Governance issued by the Central Bank of Nigeria (CBN) defines corporate governance as “a system by which corporations are governed and controlled with a view to increasing shareholder value and meeting the expectations of the other stakeholders.”

b) “Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing so, it also provides the structure through which the company's objectives are set and the means of attaining those objectives and monitoring performance.” (Organization of Economic Cooperation and Development (OECD), 1999).

c) “Corporate governance is about promoting corporate fairness, transparency and accountability” (J. Wolfensohn (1999), former President of the World Bank).

Underlying the definitions of corporate governance is the principal-agent problem which actually gives rise to the need for good corporate governance. The principal-agent problem is the recognition of the separation of ownership from control in a typical corporation, implying a loss of effective control by
shareholders over managerial decisions. The quest to reduce or eliminate the principal-agent problem in an organization is the justification for mechanisms and processes of corporate governance, ensuring the accountability of certain individuals.

II.2 Importance of Corporate Governance
Good corporate governance is a tool for socio-economic development. It ensures the integrity of corporations, financial institutions and markets which is particularly central to the health of our economies and societies and their stability.

II.3 Principles of Corporate Governance
All parties to corporate governance have an interest, directly or indirectly, in the effective performance of the organization. Directors, workers and management receive salaries, benefits and reputation, while shareholders receive capital return. Customers receive goods and services and suppliers receive compensation for their goods and services. In return, these individuals provide value in the form of natural, human, social and other forms of capital. To promote and protect the interests of all stakeholders, the following key, commonly-accepted principles of corporate governance are prescribed:

a) Rights and equitable treatment of shareholders: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.

b) Interests of other stakeholders: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

c) Role and responsibilities of the Board: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to
be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors. The key roles of chairperson and CEO should not be held by the same person.

d) Integrity and ethical behaviour: Ethical and responsible decision-making is not only important for public relations, but it is also a necessary element in risk management and avoiding lawsuits. Organizations should develop a code of conduct for their directors and executives which promotes ethical and responsible decision-making.

e) Disclosure and Transparency: Organizations should clarify and make publicly known the roles and responsibilities of board and management with a view to providing shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of matters concerning the organization should be timely and balanced to ensure that all investors have access to clear and factual information. In summary, good corporate governance is actually adherence to the tenets of corporate governance.

III.0 Risk-Based Banking Supervision

Banking supervision is the process of monitoring to ensure that banking institutions conduct their businesses in accordance with regulations and in a prudent manner. The primary goal of banking supervision is the promotion of a stable, safe and sound banking system, a critical condition for financial markets stability and sustainable economic growth. Specifically, the objectives of banking supervision are to

- Ensure financial system stability
- Protect public interest depositors, shareholders, creditors etc.
- Improve efficiency of financial institutions
- Ensure compliance with statutory/regulatory requirements.

In the past few decades, rapid technological changes, deregulation, globalization and internationalization of financial flows, increasing financial innovations, economic regionalism, and financial market failures, including the Asian crises of the late 1990s have contributed to a paradigm shift in approach to banking supervision. A rules or compliance-based approach to supervision was in operation up to 1998 and for some time thereafter. The approach involved the use of rating systems and the review of prudential returns to grade a bank. Two (2) examples of rating systems, SLEMS and CAMEL, are provided below:

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<th>SLEMS</th>
<th>CAMEL</th>
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<td>Solvency (S) – capital adequacy, asset quality, risk concentration</td>
<td>C – Capital Adequacy</td>
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<tr>
<td>Liquidity (L) – statutory, operational, concentration in assets &amp; Liabilities</td>
<td>A – Asset Quality</td>
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<td>Earnings (E) – ROA, ROE, cost/income</td>
<td>M – Management</td>
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<tr>
<td>Management (M) – governance, regulatory compliance, HR development</td>
<td>E – Earnings</td>
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<td>Systems (S) – portfolio management, accounting, MIS internal audit and controls</td>
<td>L – Liquidity</td>
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The review of relevant prudential returns and reports against pre-determined criteria complemented the system. The compliance-based approach being largely reactionary proved unable to cope with emerging challenges associated with the evolving complexities of the international financial system especially in the face of electronic payments products.

III.1 The Basle Accords - New Paradigm

In 1998, the Basle Committee on Banking Supervision (BCBS) introduced the Basle Accord (Basle I) to replace the compliance-based approach. This was the birth of risk-based banking supervision (RBBS), a proactive and relatively more efficient supervisory process. Basle I is a framework of 25 principles or recommendations on banking laws and regulations primarily focused on credit risk and prescribing a set of minimal capital requirements for banks, now widely viewed as outmoded.

In 2004, a more comprehensive set of guidelines, Basle II was introduced. Basle II uses a “three pillars” concept to promote greater stability in the financial system (1) minimum capital requirements addressing quantifiable risks, (2) supervisory review, and (3) market discipline. Under Pillar 1, more intensive procedures for computing risk-sensitive minimum capital requirements, particularly credit risk, operational risk and market risk are developed. Other risks are not considered fully quantifiable at this stage. Enhancing oversight and supervisory review is the focus of Pillar 2. It provides improved tools to regulators/supervisors and a framework for dealing with all other risks systemic risk, strategic risk, reputational risk, liquidity risk, legal risk (all known as residual risk). The promotion of greater market discipline through policies that compel banks to disclose accurate, transparent, and complete information to market players and the public is provided under Pillar 3.
III.2 Modalities of Risk-Based Banking Supervision

The practice of RBBS requires that banks bear responsibilities for understanding and managing their risk profiles and for putting in place adequate risk management structures and procedures. Banks are permitted to use their own estimates to calculate their capital requirements based on their estimated risks. The risk management frameworks of banks are reviewed by bank supervisors who must have the authority and expertise to intervene in risk management processes. Supervisors assess all risks a bank may face including, credit risk, systemic risk, liquidity risk, strategic risk, reputation risk and legal risk. Supervisory review develops and maintains a risk matrix for each bank and prepares a supervisory plan that is relevant to the current risk profile of a bank and enables the supervisor to optimize resource use by focusing on banks with a high risk profile or with high risk areas.

Supervisors continuously monitor and evaluate the risks profiles of banks in relation to their business strategies and peculiar risks and also the bank's risk management procedures and models for determining economic capital. In comprehensively dealing with current and emerging risks of banks, RBBS places an effective guard on banking/financial sector stability.

IV.0 Interplay of Good Corporate Governance and Risk-Based Banking Supervision

Banking is a business and its viability depends on the ability to make profit. This process is associated with some risks. Yet risk taking remains a vital and indispensable aspect of banking. The important thing is to accept that risks cannot be eliminated but may only be mitigated through proper management. As T. S. Fortune put it, "Risk let's get it straight upfront is good. The point of risk management is not to eliminate it; that would eliminate reward.' In other words, we define risk management as the process of identifying, measuring,
monitoring and controlling risk. The objective is to optimize risk-reward trade-off.

Four key elements identified by bank supervisors as critical to good risk management are good corporate governance; consistent application of policies, processes, procedures and limits; use of appropriate risk-measurement techniques and reporting; and adoption of comprehensive internal controls. While the first factor explicitly recognizes good corporate governance, the other factors are all aspects of good corporate governance. In other words, good risk management or risk-based banking supervision totally depends on good corporate governance. Good corporate governance in the central bank and in banks promotes effective risk-based banking supervision and effective management of risks in banks. The converse is equally the case. Poor or weak corporate governance in the central bank and/or in banks will undermine effective risk-based banking supervision and effective management of risks in banks.

IV.1 Model of Interplay between Good Corporate Governance and RBBS
The inter-linkages between good corporate governance, RBBS, financial system stability and economic growth are illustrated in the model presented below.
Risk based supervision allows banks to take risks so long as they show ability to manage and price for those risks. Risk-based supervision treats each bank on a case-by-case basis, taking into cognizance, each bank's demonstrated ability to manage risks. It does not subject well-managed banks to the same operating rules as the weak ones.

IV.2 Co-incidence of Interests

Good corporate governance and RBBS share a number of common interests: the soundness and efficiency of banking institutions, the long-term sustainability of banking/financial systems, protection of the investments of shareholders, depositors and the interests of other stakeholders, transparency and effectiveness of administration, and reliability of information disclosed. This is to be expected as both practices are interwoven.

IV.3 Issues and Challenges

As good corporate governance is pursued and integrated into the RBBS, a number of issues and challenges will need to be addressed by banks and central banks:

a) Empowerment of shareholders and directors for general effective oversight

b) Capacity of the Board to establish strategic direction, operational standards, risk tolerances and monitoring systems;
   - The Board must have the capability to effect the above.
   - A well-designed monitoring system will allow the Board to hold management accountable for operating within established tolerances.

c) Capable management and appropriate staffing essential to risk management.
   - Retaining and recruiting capable executives, line managers, risk management personnel and back-office staff can be daunting
in today's competitive job market;
- Skills and expertise of management staff must be commensurate with products and services offered by the bank;
- Skills and expertise of risk management personnel must be commensurate with variety and complexity of risks faced by bank;

d) Installation of effective risk management structures and procedures (policies/processes/control systems, risk-based auditing, management information systems etc.);

e) Monitoring of efficacy of risk management operations (compliance units);
f) Reporting on risk management performance.
g) Compliance with code of corporate governance. For example, despite the CBN's Code of Corporate Governance for Banks in Nigeria, the following undesirable conditions/activities appear to persist.
- Ineffective Board Statutory Audit Committee
- Inadequate operational and financial controls
- Lack of transparency in operation, market efficiency and discipline
- Board/Management squabbles.

For supervisors, the pursuance of good corporate governance as an integral part of RBBS requires preparedness to effectively implement RBBS, development of a code of corporate governance for banks and capacity for effective monitoring of banks' corporate governance performance. These are formidable, time-consuming challenges given the pre-RBBS conditions of central banks and banks and the huge investments in staff capacity building, institutional infrastructure and consultancy services necessary for the transition to RBBS.

For example, bank regulators and supervisors must rise to the high ground of expertise and understanding of emerging market instruments and practices to
develop models, assumptions and risk views of banks, and certify the risk management of banks. They should be able to assess the quality of a bank's procedures for evaluating, monitoring, managing and controlling risks and the bank's models for determining economic capital. Banks and bank supervisors need to deal with these challenges of good corporate governance for RBBS.

V Way Forward
All stakeholders in the banking system have responsibilities for good corporate governance and banks, in particular, have responsibilities for risk-based banking supervision. From experience, it cannot be taken for granted that these responsibilities are appreciated well-enough. Rather, continuous emphasis and enforcement of these responsibilities are needed more now than ever before. The current international financial crises have been attributed to long-standing inadequate regulation. Nobel Laureate, Professor Joseph Stiglitz argues that stronger regulation relating to corporate governance, pay, lending practices etc. is necessary if the world is to avoid a similar crisis in the future. Indeed, the failures of regulation and supervision will always lead to disaster for banking and financial systems. Thus, re-dedication and practical commitment to the responsibilities and principles by banks and central banks are required for the way forward with respect to corporate governance and RBBS:

- Ownership and enforcement by the Boards of a code of corporate governance.
- The Board must satisfy itself that the implementation, integrity and maintenance of effective risk management systems are not compromised.
- Management must keep directors adequately informed about risk-taking activities.
- Management must ensure that strategic direction and risk tolerances are effectively communicated and adhered to throughout the organization. The quality of supporting human resource and organizational orientation
and back-up need to be addressed.

- Management must oversee the development and maintenance of management information systems to ensure that information is timely, accurate and pertinent.
- Central banks must make the investments required for the successful implementation of risk-based banking supervision through addressing human resource development in risk-based supervision, infrastructural support and risk-based auditing.
- Establishment of risk-based internal audit and functional compliance units and management review of their operations.

VI Conclusion

We have witnessed in today's world the near-collapse of the international financial system, which reverberated across many continents and national economies. Good corporate governance in financial institutions and effective risk-based banking supervision in banks possess the strength to stave off this adversity. It rests with boards, management, regulators and supervisors of banking/financial institutions to operate according to the tenets of good corporate governance and risk-based banking supervision to spare the world from future financial crises.