

Corporate Governance Developments in Financial Institutions

The global financial crisis has focused attention on the crucial importance of effective corporate governance and risk management in preventing loss and failure in the financial system. Ineffective boards and weak senior management oversight in some of the largest global financial institutions were key contributing factors to the significant financial losses that were incurred. In many cases, institutions failed to understand and monitor the implementation of business strategies and associated risks being assumed, and to respond quickly and appropriately to deteriorating market conditions. By the same measure, institutions that performed better during the crisis were consistently differentiated by more robust governance and risk management practices in these institutions.

In the recent period, reactions to the crisis have seen international standard setters, including the Financial Stability Board and regulators in several major economies, directing attention firmly to corporate governance as a key reform agenda. The reforms have focused in particular on:

- (i) achieving an appropriate balance of skills, experience and independence in boards of financial institutions;
- (ii) strengthening board practices with increased expectations on the role, commitment and performance of the chairman and board committees;
- (iii) ensuring the effective functioning of the board on a continuing basis through a formal evaluation process and improved disclosures;
- (iv) achieving more effective approaches to induction, training and continuing development of non-executive directors to ensure that the board is kept well-informed of new developments in the financial industry;
- (v) strengthening board-level engagement in risk oversight through dedicated board risk committees that are supported by an independent chief risk officer; and
- (vi) enhancing board-level oversight of remuneration practices so as to avoid incentives for excessive risk-taking.

These developments are consistent with the direction and emphasis of changes that have shaped corporate governance practices in Malaysia's financial sector for some time now. Following the Asian financial crisis in 1997, strengthening corporate governance has been a central focus of capacity building measures aimed at providing a strong foundation for a stable and more resilient financial system. A strong corporate governance framework, supported by sound governance practices, was also identified as a key imperative for the transition from a prescriptive, rule-based regulatory regime to a more principle-based regime with greater reliance placed on the internal oversight functions within financial institutions to manage and control risks.

The resulting prudential standards on corporate governance which have been adopted for financial institutions in Malaysia are built on the following key tenets:

- (i) **clear separation of management and oversight functions** – this is enforced through the separation of the roles of chairman and chief executive officer, a strict limit on the number of executives on the board, a requirement for key board committees (namely the audit, risk, remuneration and nominating committees) to be wholly constituted of non-executive directors, and clearly delineated accountabilities between operating units and independent control functions;
- (ii) **adequately competent and committed boards** – to ensure commitment to the affairs of the financial institution, board members are expected to minimise the number of outside board directorships held that would dilute attention to the financial institution. The board must also collectively possess the requisite experience and expertise to be able to constructively challenge and guide management, particularly on risk issues and strategy. Institutions must additionally meet specific expectations regarding the orientation and ongoing training of directors;

- (iii) **presence of a strong independent element on the board** – at least a third of the board of directors of a financial institution must be independent of both management and significant shareholders;
- (iv) **a clear, explicit and dedicated focus on the oversight responsibilities of the board for risk, internal controls, remuneration, and directors and management performance and succession** – since 2005, all financial institutions have been required to establish an audit committee, a risk management committee, a remuneration committee and a nominating committee to support the effective oversight of the board in these functional areas. In the case of Islamic finance, the establishment of a Shariah Committee mandated with specific responsibility for the overall oversight of Shariah compliance is also required;
- (v) **rigorous fit and proper assessments for key functionalities** – board members, senior management and officers primarily responsible for control functions must comply with fit and proper requirements both on appointment and on a continuing basis, and financial institutions must ensure that a robust process is in place and operates effectively to ensure this;
- (vi) **incentive structures that are aligned with long-term performance and the interests of depositors and policyholders, in addition to shareholders** – boards are required to institute and monitor effective internal controls and risk management systems that address risks on an enterprise-wide basis, and avoid remuneration practices that may create incentives for irresponsible behaviour;
- (vii) **explicit responsibilities of the board for related party transactions** – boards are required to establish policies and procedures, including defined limits and appropriate approval and monitoring procedures, to ensure that risks from related party transactions are effectively managed. Boards must also ensure that policies are established to identify, prevent or appropriately manage and disclose potential conflicts of interests; and
- (viii) **sufficient reporting and disclosures on corporate governance practices** – financial institutions must describe how prudential standards are complied with, or explain any material departures and alternative measures taken to meet the intended objective of the standards. Disclosures must include information on the composition, functions and conduct of the board and its committees, an institution's risk exposures and risk management systems and an assessment of the effectiveness of the key internal control (including risk control) functions.

Observance of these prudential standards forms an integral part of the Bank's supervisory assessments of the safety and soundness of financial institutions under its Risk-Based Supervisory Framework. Assessments of the quality and robustness of an institution's oversight and control functions are both the starting point for supervisory evaluations of how an institution is managing the risks inherent within each of its significant areas of activity, and the basis on which the Bank forms an overall view of an institution's resilience, particularly under stress conditions. Recognising that financial resources are limited and often constrained during periods of stress, the emphasis on governance practices represents a critical complement to the Bank's assessments of an institution's financial performance and capital position. Emphasis is directed at how an institution's policies, processes and internal controls support prudent risk-taking that is commensurate with the level of capital and capabilities of the institution. The Bank also reviews whether these policies, processes and control mechanisms are in fact operating effectively across the institution. The outcome of these reviews is the single most important consideration in determining the intensity of supervision applied to an institution and by extension, the degree of flexibility accorded to the institution in managing its business.

Today, there is increasing evidence of practices among financial institutions in Malaysia exceeding the minimum prudential requirements and which underscore a significantly strengthened risk and governance culture. In a recent survey conducted on financial institutions in Malaysia, non-executive directors indicated an increasing commitment of time (including preparation for, and attendance at board meetings) devoted to the affairs of the financial institution, ranging up to 60 days a year. In 60% of financial institutions, more than half of current board members have direct financial sector

(including previous management) experience. This is further supported by a good mix of relevant qualifications and experience represented on the board as a whole. Independent directors form the majority on more than half of the boards of all banking institutions. More recent developments have seen a pronounced elevation of the status of the chief risk officer with strengthened authority for the management and oversight of risk at an enterprise-wide level. Several institutions have strengthened the full independence of the chief risk officer by formalising a functional reporting line directly *and only* to the board risk management committee. Improvements have also been observed in engagements between board and management on risk matters, with boards assuming greater control over the content, timing and presentation of risk information to the board. This, in turn, has supported a better appreciation of key risk developments by the board. Evidence of more engaged boards can also be observed from the retention of external expertise by some institutions to advise the board on specific issues where the board as a whole lacked the necessary knowledge and capability needed to reach informed decisions independently of management.

The introduction of the Financial Institutions Directors' Education (FIDE) programme in 2008 has played an important role in further strengthening the capacity of boards of financial institutions in Malaysia. In the 14 months since its launch, 131 directors have completed the FIDE programme. The Bank's interactions with directors who have completed the programme revealed a deeper appreciation among directors on the importance of individual contributions to the board function, a renewed confidence in engaging management on risk and strategic issues, and more effective leadership demonstrated by chairmen towards improving the functioning of the boards and board committees over which they preside. The FIDE programme has also been credited with encouraging more thoughtful approaches by boards to the selection and evaluation of board members and senior management, and a firmer hand in addressing issues of conflict and inappropriate interferences with the oversight function.

Recent global deliberations on international financial reforms have focused on the size of financial institutions with the prospect of reducing the social and economic costs of systemic failures by limiting the scale and complexity of financial institutions. In Malaysia, the financial sector is likely to expand and become more complex over time. While financial institutions in Malaysia have made significant advances in the area of corporate governance, governance practices will need to continue to evolve to take into account the changing environment. In the immediate to medium-term, pertinent developments include the greater use of and reliance on sophisticated risk management tools to identify, measure and manage risks with the implementation of the Internal Ratings-Based Approach under Basel II and the Risk-Based Capital Framework for Insurers. In addition, higher volatility and potential contagion exists as more financial institutions expand across borders and financial markets become more integrated while uncertainties remain in the pace and strength of global recovery. Other developments include the changing regulatory landscape which envisages more stringent capital requirements, more discretionary accounting practices and more explicit expectations of financial institutions to manage capital resources using through-the-cycle approaches. The development of Islamic finance will gain further momentum leading to an increasing array of new Islamic products and instruments, thus posing unique Shariah challenges. Intense competition in certain market segments have also returned the appetite for financial innovation, while competition for talent will similarly intensify.

It is the role of the board to understand how institutions are affected by these developments and consider how governance practices need to be adapted to maintain effective oversight and control. The issues for boards include:

- the design of processes and structures for effective oversight at the group level and on a cross-border basis;
- appropriate controls over the use of models and the exercise of management discretion and judgement;
- the effective integration of risk management and internal control functions and how these should interact to support the ongoing oversight of risk;
- continuing and sustained oversight of how incentive structures within the institution are responding to risk, competition and innovation;

- approaches for more effective engagements with stakeholders as part of efforts to manage expectations and preserve confidence particularly in times of stress;
- effective design of programmes for board members to be continuously kept abreast of the latest developments in the financial industry; and
- in Islamic finance, the need to account for the unique features of Shariah principles in risk management and governance.

Financial institutions in Malaysia are well placed to respond effectively to these issues, building on the institutional framework and arrangements that have been put in place over the decade following the Asian financial crisis. Enhancements to the regulatory framework on corporate governance and risk management are being pursued to respond to new developments, further promote good governance practices and reflect on lessons from the global financial crisis. The legislative framework will also be strengthened to codify the fiduciary duties and responsibilities of directors of financial institutions. With continued priority accorded to governance issues in both the supervisory and organisational frameworks, the ongoing evolution of sound governance and risk management practices will further reinforce the foundations for financial stability while enhancing the long-term competitiveness of the Malaysian financial sector.