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Preliminary Scorecard on Corporate Governance Reform in the Banking Sector

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PRELIMINARY SCORECARD ON CORPORATE GOVERNANCE REFORM IN THE BANKING SECTOR

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Introduction

The title the organizers gave to my paper is felicitous, since it expands its coverage beyond my original topic, a Preliminary Report on the Corporate Governance Scorecard Initiative for Banks in East Asia. Since work on my topic is very much at its initial stage, with a final report expected only in September 2005, I welcome this expanded coverage. It does give me a wide enough room to put in context the initiative we are undertaking under PECC auspices: that undertaking is to present a full framework, with initial results, for a corporate governance scorecard for banks at least in the East Asian area.

That corporate governance reform has become a matter for serious concern, particularly in East Asia, is in little doubt, especially if we note the frequency with which it is referred to (and talked about) in the area.

In virtually all economies of East Asia, however, capital markets still play a smaller role in the sourcing and provision of external corporate finance relative to banks. Thus, while in the US and UK there has been a natural tendency to deal with corporate governance reforms as a matter of concern in and through the capital markets, within East Asia generally corporate governance reforms need to be pursued more in and through the banks.

The many reforms and changes that banks have been undertaking, either in the aftermath of the East Asian financial crisis or in view of the coming to force of the BIS agreements, particularly although not exclusively those on capital adequacy ratios, have opened a good opportunity to introduce corporate governance reforms in and through the banks.

It is in this broad context that corporate governance reforms in the banking sector are being considered as one more area for greater cooperation at least within East Asia, and more broadly in the Asia Pacific region.

A Scorecard for CG Reform in the Banking Sector

In promoting corporate governance reforms, each economy uses the levers that may be available in order to initiate and eventually force the pace of reforms. Understandably, each economy follows a pathway that may be open to it. This pathway is necessarily different for each economy.

However, after a few years of talking about corporate governance reforms and experimenting with initial steps to take in pursuit of them, at least in several economies in East Asia there is a pattern of the more promising steps that is emerging. The pattern is far from common, but already there is some active conversation going on to exchange notes of experience on at least five steps that have advanced the cause of CG reforms in the banking sector in some economies in the area.

The *first step*, already widely taken in many economies in East Asia, is the regulatory requirement for bank directors to take an Orientation Seminar on corporate governance. This requirement has become an essential component of the "fit and proper" test for bank directors: they can continue to stay in any bank's Board of Directors only if they can show proof that they have in fact attended such an Orientation Seminar. The seminar outlines the OECD core principles of corporate governance as well as the local laws and regulations, especially those that stress the duties and responsibilities of bank directors. In view of this particular "fit and proper" test, this requirement has already been met by almost all bank directors in several East Asian economies.

Attendance at an Orientation Seminar may make bank directors conscious of their duties and responsibilities as the core corporate governance principles and local laws and regulations may specify. But it does not necessarily lead to any specific action that bank directors may immediately take to improve their corporate governance practices. Thus, a *second step* has become necessary: bank regulators have mandated that several Board Committees be set up, and "independent directors" should constitute the majority in these committees. Of special interest for real corporate governance reforms are 3 Board Committees: Audit, Risk Oversight, and Governance (this latter to take on such duties as director nomination, continuing education, performance evaluation, and remuneration). Having to set up these Board Committees and making them function properly, several bank directors who are asked to serve in them find themselves in need to focus on the many demands of their directorship. They have to put in more time. They have to do much more work. They also have to get some specialized training. And they become more deeply aware of their serious duties and obligations as bank directors, made concrete and specific through their involvement in Board Committees. Moreover, particularly in the case of "independent directors", they begin to be acutely aware that they are putting their professional reputation on the line by being a bank director. Thus, the pressure to “perform” accordingly and act professionally becomes more intense.

But how do bank directors know that they are performing their functions accordingly? This is where the *third step* comes in, that of maintaining a corporate governance scorecard. This is nothing more than a tracking tool, which enables bank directors to measure their progress towards complying with “best practice guidelines”. Through such a tool, there is an occasional but regular comparison between current, actual practices, either in the Board itself or in some specific Board Committees, and selected best practice guidelines. These guidelines may come from the bank regulators themselves or from independent local institutes of directors, which try to adapt global CG principles and practices to local circumstances. By making such a comparison, bank directors can get a sense of the gap between what they are doing and what is being suggested they should be doing. And the tracking tool---the CG scorecard they use regularly---enables them to monitor whether they are narrowing and eventually closing the gap. Presumably, they can do so by having an honest-to-goodness corporate governance improvement program for their bank: this has to be action-specific and time-bound.

The *fourth step* opens up precisely because a corporate governance improvement program is being implemented in bank governance. That program demands an increasing level of professionalization in the practice of bank directorship. This would require that in addition to the conformance roles (supervision and monitoring as well as installing a system of accountability) that bank directors undertake, performance roles have to be emphasized as well. In fact these latter, which include policy and strategy formulation and may extend to fostering a bank culture of ethics and social responsibility, should be making considerably more demands upon bank directors. How bank directors raise their level of professionalization in the practice of bank directorship is completely up to them. Fortunately, however, in an increasing number of East Asian economies, Institutes of Directors have been set up. These institutes have geared themselves up and equipped themselves with the capacity and competence to offer a Professional Directors Program, which can easily be custom-fitted to the demands of bank directors.

In fact, the demands of professional directors, whose independent judgment of many critical issues related to the performance role of a bank’s Board of Directors is more assured, extend to the much broader regime that influences bank corporate governance practices. This broader regime is shaped by the norms and actual practices that several “reputational agents” and the bank regulators as well as other regulators observe. It is also shaped by the standards and codes actually observed in the economy as a whole, not only in the banking and economic sectors but also in the administrative, judicial, and political sectors as well. Thus, bank directors cannot be indifferent to the conditions and changes in the bank’s broader environment. And in many developing economies---

particularly those in East Asia---these norms and practices as well as these standards and codes need to be reviewed regularly. As a result of such a regular review, an action program is formulated and pursued, eventually to be assessed at the end of period that the action program covers. In the formulation, implementation and assessment of such an action program, designed to improve the over-all corporate governance regime in the economy, bank directors should take an active role. It is this active role in corporate governance reform advocacy that constitutes the *fifth step*.

The pattern that these five steps are shaping for corporate governance reforms in the East Asian area is just now emerging. It is necessary to continue the dialogue on these five steps as well as on others that may be even more effective in advancing improvements in bank corporate governance practices. As the dialogue firms up a consensus on the desired pattern, it should then be possible to devise a scorecard for CG reform in the banking sector, starting with participating East Asian economies. The scorecard can help monitor how far each bank and the banking sector in each economy in the area has gone with regard to the commonly agreed steps. It should be stressed that such a scorecard simply serves as a tracking tool to monitor actual progress in improving CG practices in banks and eventually through the banks in any economy. This is because as the new BIS agreements come into force, a similar scorecard can be devised for banks to consider applying to their most important borrowers, with a potential for having a systemic effect on an economy.

It is not farfetched to suggest, taking into account the initiatives that have already been taken in many East Asian economies, that a preliminary scorecard on CG reforms in the banking sector be devised (Please See Annex 1- Bank Corporate Governance Scorecard Self-Assessment). Such a scorecard should be made on a regular basis. After some time (say after three years), it should be possible to expand it to include CG reforms in an economy as pursued through the banking sector.

A Possible Framework for a Bank CG Scorecard

In East Asia, or more generally in the Asia Pacific region, we already have a common set of guidelines for proper practices of corporate governance. This set of proper practices were adopted in Shanghai during the Ministerial meetings of 2001 and endorsed during the succeeding Economic Leaders' meeting (also in Shanghai). These guidelines provide a useful head start for initiating a bank corporate governance scorecard.

Following the Shanghai Guidelines for proper CG practices, the bank scorecard can consider the following "umbrella" areas:

1. The Board as a whole

2. The Chairman
3. The Members of the Board
4. Board Meetings
5. Board Committees and Issues

Each of these broad "umbrella" areas covers specific points taken from the Shanghai Guidelines.

For a bank CG scorecard to be devised for participating economies in East Asia, there would need to be at least a review of the Shanghai Guidelines. There should also be a determination of the relative importance (i.e. weights) to give each point within a given area, and subsequently to each of the five umbrella areas listed above. Where only one economy is involved, these weights may be determined by the bank regulator, or the bankers' association, or the local institute of directors, or by a consortium of all three. But where several economies in an area are involved, e.g. in East Asia, it is necessary to forge a consensus on the relative importance to give to each point in the Shanghai Guidelines and to each of the five umbrella areas. An agreed set of weights would make the resulting scorecards comparable, not only between banks, but also between banking sectors in the different participating economies.

However, taking into account the 5 steps outlined earlier, it is also necessary to go beyond the Shanghai Guidelines, which refer only to the general principles and set of proper practices of corporate governance. Step 2 above already goes much farther: it includes proper practices for a few Board Committees, such as Audit, Risk Oversight, and Governance (nomination, continuing education, performance evaluation, and remuneration). And step 4 brings in still more proper practices, this time including those that shape a culture of compliance, performance, ethics and social responsibility (Please See Annex 2- ICD Expanded Guidelines for Proper Corporate Governance Practices). There is an imperative for an exchange of views between participating economies on these additional proper practices. As in the case of the Shanghai Guidelines, some consensus needs to be forged on their formulation as well as possible use as a common reference for banks in the area. And once such consensus shall have been arrived at, there would also need to be an agreement on the relative importance (or weights) to give to each point agreed upon.

Once such a framework has been agreed upon, it should now be possible for individual banks to use it. The challenge becomes one of going from mere "possibility" to actuality. In other words, banks should move to the point of actually using the scorecard and applying it to themselves. A combination of influences can be brought to bear to help bring this about.

a) A significant push for a Professional Directors Program, specifically adapted to the needs of bank directors, can lead to the formulation of a corporate governance improvement program in several banks. Such a program can use a bank CG scorecard as a tool for monitoring progress. This influence may well be the most desirable and sustainable, it being much more purely voluntary and responsive to a felt need.

b) The bankers' association may also adopt a bank corporate governance scorecard initiative as a project to signal the sector's seriousness in promoting corporate governance improvement. This would involve the leadership of the banking sector, and it has the advantage of including every important banking institution in the economy.
c) The bank regulatory authority, in addition, could mandate that each bank uses a CG scorecard and includes it in the coverage of its regular examination of the banks under its supervision. This has the advantage of pressuring the banks to take corporate governance much more seriously, and in an East Asian context this advantage can prove to be considerable.

These different influences need not be mutually exclusive. In fact, they can support each other; and the ideal is to have all three reinforce each other within each economy. Here again, however, the principle of using whatever lever is available needs to be observed. In those economies where only one or two of such influences can be brought to bear on banks, the bank CG scorecard initiative can still proceed, albeit under less than ideal conditions.

The influences that can be brought to bear on banks to push forward with this initiative would help shape how the framework for the bank CG scorecard can be used to come up with actual scores.

a) Where individual banks participate largely on a voluntary basis, self-rating is observed. Bank directors in participating banks, generally during their performance evaluation exercise, can be guided to rate the corporate governance practices they observe in relation to the best practice guidelines. With the assistance of an independent institute of directors, the self-rating scores can be put together to come up with a completed scorecard at a point in time (i.e. as of a given date). Over time, these scores can be compared in order to track progress made. This may have the disadvantage of subjectivity. However, in the experiment that has been conducted involving all the major banks in an economy, no consistent, significant bias was reported.
b) Where the bankers' association is involved, cross-checks can be provided by peer rating, which should be much less subject to the danger of bias. But in this case, the involvement of an independent institute of directors should be much stronger to ensure the proper selection of peers: these would have to be bank directors fully committed to the high professional standards of bank directorship in an economy.

c) Where the regulatory authority looks more closely into a mandated bank corporate governance scorecard, the bank examiners' observations and judgments can help enrich those that may have been made earlier by the bank directors of the bank being examined. Presumably, the bank examiners' views should be much more informed and objective.

Ideally, with strong impetus that the regulatory authority can give, the results of self-rating, rating by peers, and rating based on observations from bank examiners can be put together, following a pre-agreed process. An independent institute of directors may be tasked to ensure that the process is followed properly and fairly.

The frequency for issuing the results of a bank CG scorecard initiative, involving several parties (banks, the bankers' association, and the bank regulatory authority) can only be annual. Sustained over a few years, however, the scorecard can be a tool for tracking progress in improving actual corporate governance practices in bank boardrooms.

It is in this light that this initiative can be important in moving banks in East Asia from the level of referring to and talking about corporate governance reforms to one of acting and moving on with those reforms. Moreover, the pace of progress can also be tracked. In the process, as banks make further progress in their own corporate governance practices, they would gradually pass on the same concern and interest for proper corporate governance practices at least to their most important clients. Once banks get to this point, they would become effective and instrumental in promoting CG reforms in their respective economies.

With a CG scorecard across economies that would be comparable---not only between banks but also eventually between corporations that borrow from banks---the interest of the international investment community in CG reforms, particularly in East Asia, would be much better served. Not incidentally, the interest in and of the different economies in East Asia would also be sustained and further heightened.

Manila, June 10, 2004