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Corporate Governance and Banking Crisis

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I presented the following paper at the Eastern Caribbean Central Bank's 26th Annual Conference with Commercial Banks held in St. Kitts on 05 November 2015. The paper reflects the research and findings by the OECD Steering Group on Corporate Governance published over the post-crisis period 2009 to 2010, infused with my own thoughts and experience on the subject, with some suggestions for the way forward.

The 2008 financial crisis revealed deep shortcomings in corporate governance. Indeed, perhaps when they were most needed, existing governance standards failed to provide the required checks and balances that are so critical to engender sound business practices in both financial and non-financial firms. Lest we waste the crisis as they say, I would like to shine a light on some key governance issues with particular reference to banks, which in my view remain as relevant today as they were in the pre-crisis period.

1. Boards are simply not as effective as they should be

A key function of a bank's board is to monitor the effectiveness of the bank's management practices and initiate changes as needed. This monitoring of governance by the board also includes a continuous review of the internal structure of the bank to ensure that there are crystal clear lines of accountability for management throughout the institution, as well as integrity in the bank's accounting and reporting systems, and appropriate systems of risk management, financial and operational control. The research shows that this internal aspect of governance did not receive the attention it deserved by boards of financial institutions in the build-up to the crisis, and is probably still the case post the crisis. The impact of this was that the reliability and independence of reports coming to the board were called into question due to a lack of proper separation between line management or profit centres and risk management or control functions. To be clear I am not advocating 'micro managing' by the board, which by the way in my view are two of the most misused words in management discussions today, but rather it is about encouraging boards to be more comprehensive and effective in their monitoring of governance and governance structures in the company, thereby ensuring that they are being fed with reliable and accurate reports for decision-making.

Another issue which caused problems worldwide and is certainly relevant to the Caribbean is the dominance of boards by the CEO, which may have had the effect of stifling critical enquiry and challenge essential for objective, independent judgement. The strength of the Chair is obviously called into question here and it is important for the Chair to play a key role in ensuring that the board tackles the most important issues facing a company and that all members are comfortable to raise issues and concerns at all points in time.

Yet another issue is multiple directorships, a common feature in the Caribbean. The issue here is that board members should be able to commit themselves effectively to their responsibilities, and service on too many boards can interfere with the performance of board members. In my opinion the Chairman is best placed to judge this, not only from the track record of attendance by the member, but also from the quality of contributions when he or she does attend. I am sure we are all familiar with the super director who attends board meeting without diligently reading the prepared board papers and "shoots from the hip" throughout the meeting much to the dismay and pain of senior management who might have spent countless hours preparing these papers. The question of availability of suitable candidates in the Caribbean always arises, but I believe the aim of including not only experienced CEOs of other companies but also senior executives, both male and female, with expertise in specific areas widens the pool.

The quality of board members is a particular concern, but fit and proper person tests often do not fully address the issue of competence. Going forward, for banks and financial companies where board members are subject to a fit and proper test, good practice will be for such tests to extend to the technical and professional competence of board members, including general governance and risk management skills. Also, to perform better boards will need to be supported in key areas. To promote competent and more effective boards, board members should have access to relevant training programs and subject themselves to annual external board evaluations, thereby instituting a framework for improvement.

Enterprise Risk Management needs to be much more aggressively embraced

The research shows that the banks that avoided major problems in the crisis displayed a more comprehensive approach to viewing firm-wide exposures and risk, sharing both quantitative and qualitative information more efficiently across the firm and engaging in more effective dialogue across the spectrum of the management team. These banks employ more adaptive rather than static risk measurement processes and systems that could very quickly change underlying assumptions to reflect current circumstances. They also employed more effective stress testing and scenario analysis, and in short they exhibited stronger governance systems since the information was also passed upwards to the board. Obviously size and complexity feature here, but going forward stress testing must form an integral part of a bank's risk management practice and managers of all disciplines should be involved so that outcomes have a meaningful impact on business decisions.

Relatedly, giving risk managers more teeth is still a matter to be addressed. This has been done successfully where the Chief Risk Officer (CRO) reports directly to the CEO or where the CRO has a seat on the board or management committee. To have a strong independent voice, the CRO should have a mandate to bring to the attention of both line and senior management, as well as the board, any situation that could materially violate the bank's risk-appetite guidelines.

Room for improvement in regulatory frameworks

Weaknesses in regulation and regulatory frameworks also featured in the blame list for the financial crisis. In many cases, the regulator's internal processes did not lend to timely and effective decision-making, and this may still be the case. In some instances the regulators were subject to potentially conflicting objectives of investor protection and maintaining the safety and soundness of institutions. The analysis shows that jurisdictions need to regularly review the capacity of their supervisory, regulatory and enforcement authorities and to make sure they are sufficiently resourced, independent and empowered to deal with corporate governance weaknesses. Forward looking capacity needs to be built and for new legislation full use should be made of both ex ante and ex post regulatory impact assessments. Where there is a corporate governance code, implementation should go beyond box-ticking, and it is important that an independent body be charged with monitoring implementation and facilitating timely updates.

Executive remuneration/incentive systems still need to be addressed

Better governance of the executive remuneration/incentive system is needed. Too often negotiations and decisions are not carried out at arm's length. Managers and others have had too much influence over the process with boards unable or incapable of exercising objective, independent judgment. What is clear in my mind though, is that in many cases the link between performance and remuneration is very weak or difficult to establish. The goal obviously is for reward systems to encourage long term performance and this requires the design of instruments to reward executives once the performance has been realised, and therein lies the challenge. Good practice for banks is to defer a percentage of the executive's compensation for some years and link the deferred payment to the performance of the loan portfolio over these years. Generally speaking pay for performance should only be paid or accrued if the company exceeds or meets measureable performance targets and not simply due to the passage of time.

Management style and candour matters

A management culture that encourages openness, freedom to challenge and intellectual curiosity, feeds innovation and can convert seemingly insurmountable challenges into opportunities. Further, senior executives should be conscious that the words and linguistic patterns used in executive communications, such as in the CEO's Report in the company's Annual Report, provide valuable insights into the company's corporate culture – research has shown that the shares of companies whose executives exhibit a high degree of candour have outperformed shares of candour-deficient companies. Reports loaded with FOG (acronym for Fact-deficient, obfuscating generalities) typically represent a leading indicator for miserable performance by the entity. Quite simply, a CEO who misleads other in public may eventually mislead himself in private. Executives who lack a commitment to candour will be handicapped in creating trusting relationships with stakeholders. Without trust, the business cannot perform at optimal levels. Executives with trust-deficient cultures can expect to create confusion and even fear – internally and externally. These qualities are toxic to creating sustainable shareholders wealth. When fear dominates a corporate culture, expect to find poor execution and thinking and, ultimately substandard results. To crystallise the point here, words reveal the integrity of leadership.

They can signal the existence of fear-based corporate cultures or reveal creative problem-solving cultures. Investors can learn a great deal about a company's CEO by looking at his or her vocabulary.

Process trumps Analysis

Investment and lending decisions can be improved through better 'decision governance' i.e. Process trumps Analysis. Research shows that the process is 6 times more important than analysis and can make a difference of 100 bps per year in the performance of an investment portfolio. This is why the existence of so called 'stars' in a financial institution is in the long run riskier than the seemingly less outstanding individuals who are committed to following due process in arriving at a lending or investment decision – while the stars may make millions for the institutions and appear that they can do no wrong, in one deal they can cause losses in the billions from not following due process.

A role for independent and professional credit rating agencies

At this point, acutely aware of my enlightened self-interest, I unashamedly make a call for the maintenance of independent credit ratings by all banks in the Caribbean and I would even say all deposit taking institutions above a minimum asset size. An independent credit rating must be seen as an integral component of a bank's governance framework and an important input into its enterprise risk management framework. The rating examines on a current and forward-looking basis the bank's adequacy of capital, funding position, asset quality, profitability, liquidity and most importantly the quality of its management and risk management policies and framework. Having an independent and external opinion on the bank's financial soundness and creditworthiness can be extremely useful and beneficial not only to the bank itself, as the rating report provides a blueprint to improvement in the parameters listed before, but also to the regulator, as the rating provides a second opinion from a qualified expert on the bank's key risk metrics and exposures.

This call for a credit rating is not oblivious of the role that the international rating agencies played in the financial crisis, but I submit that the conditions that led to the international agencies cutting corners and breaching conflict of interest norms are quite different from what prevails in the Caribbean. The international rating agencies were under considerable commercial pressure to meet the needs of their clients, particularly in the collateralised debt obligations asset class, and assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models.

In closing, I submit that good governance is really about good leadership, and while strong corporate governance may be able to carry a weak bank through very difficult times, weak governance on the other hand can easily wreck a financially strong bank, even in the best of times.

29 October 2015