Asian Shadow Financial Regulatory Committee

Governance of Financial Institutions in Asia: Lessons from the Financial Crisis

Singapore, July 15, 2010

Statement No. 14

The global financial crisis of 2008/2009 showed once again the importance of effective corporate governance, especially for large and complex financial institutions. The recent efforts to strengthen governance of these financial institutions reflect a new recognition that not only governments but also boards of directors (BoDs) of these institutions should play an active role to assist in protecting taxpayers as well as investors.

The European Commission's Green Paper of June 2010 on corporate governance in financial institutions and remuneration policies refers to the need for financial institutions taking better account of the interests of depositors, thereby implying taking better account of the interests of taxpayers at large. This is in contrast to the focus on protecting shareholders from management's misbehaviour (US/UK model); minority shareholders from controlling owners' misbehaviour (Asian model); and workers from management's/shareholders' misbehaviour (continental European model).

In addition to efforts regarding control of leverage, capital and liquidity requirements, transparency and general risk management, a need exists for imposing new rules for better internal risk management. This could be done through a well functioning board of directors in the context of the existence of more complex financial products and the systemic risk embedded in large financial institutions.

With respect to the role of the board of directors it should be recognized that many Asian countries display some unique characteristics: family and/or state control of financial corporations rather than diffused ownership, and challenging legal enforcement issues. These characteristics combined together require an even more enhanced role of BoDs in Asia. Longer planning horizons and risk

taking behaviour during financial distress may hurt minority shareholders. In the Asian setting, controlling shareholders, be it a state or a family, tend to have more discretionary power in management subjecting minority shareholders to a greater risk of exploitation.
In order to better cope with this situation in Asia, improvements in the governance of BoDs become more critical. Therefore, it would be desirable for Asian countries to adopt more than the rules and regulations being proposed in the US and Europe in order to improve the effectiveness of the BoDs, in particular of large and complex Asian financial institutions.

Specifically, Asian countries face two impediments to having well functioning BoDs. First, cultural differences imply less emphasis on formal contracts and more obedience to authority in Asia. Second, Asia has a limited pool of qualified independent directors as the requirement for independent directors is relatively new to the region, only gaining momentum after the Asian financial crisis in 1997.

The first impediment could be partly overcome through externally imposed rules on the governance practices of BoDs. The best way to do this is to make some measures mandatory and others in the code of best practices (or guidelines) subject to “comply or explain.” The second impediment could be partly overcome through more rigorous and purposeful training of BoD members and continuous development of director education.

In view of the above characteristics of the Asian situation the Asian Shadow Financial Regulatory Committee (ASFRC) recommends the following.

1) Mandatory training for incumbent and prospective independent directors to improve their skills and expertise.

2) Time commitment for independent directors of financial institutions should be at least 30 working days per year. Such time commitment is very important for independent directors, particularly those of financial institutions. In addition many Asian institutions are less mature system-wise and therefore need more effort to build up systems, procedures and processes.

3) Independent directors should be independent from management, business relationships and substantial shareholders. Moreover, to ensure their on-going independence they should serve only a limited number of years, e.g., six to nine years. We also strongly advocate the separation of the board chairman from the CEO. In addition, the appointment of a lead

independent director is critical to facilitate mandatory meetings of independent directors.

4) A majority of independent directors on the board is essential, but given a paucity of qualified independent directors, this could be mandated over time.

5) All financial institutions should set up a Risk Management Committee (RMC) within the board and appoint an independent Chief Risk Officer (CRO) who reports directly to the RMC. This requirement is particularly important for Asian institutions since they are more likely to be influenced by family or state owners.

The new recognition by governments that financial institutions should assist in protecting taxpayers as well as investors creates new challenges for BoDs. This can create a potential dilemma which needs to be handled with an appropriate mindset as suggested by Fitzgerald's First rate intelligence:

> *"The test of a first-rate intelligence is the ability to hold* ***two opposed ideas*** *in the mind at the same time, and still retain the ability to function."* (F. Scott Fitzgerald, "The Crack-Up", 1936).