

Role of Directors: Relationship Between Board & Management

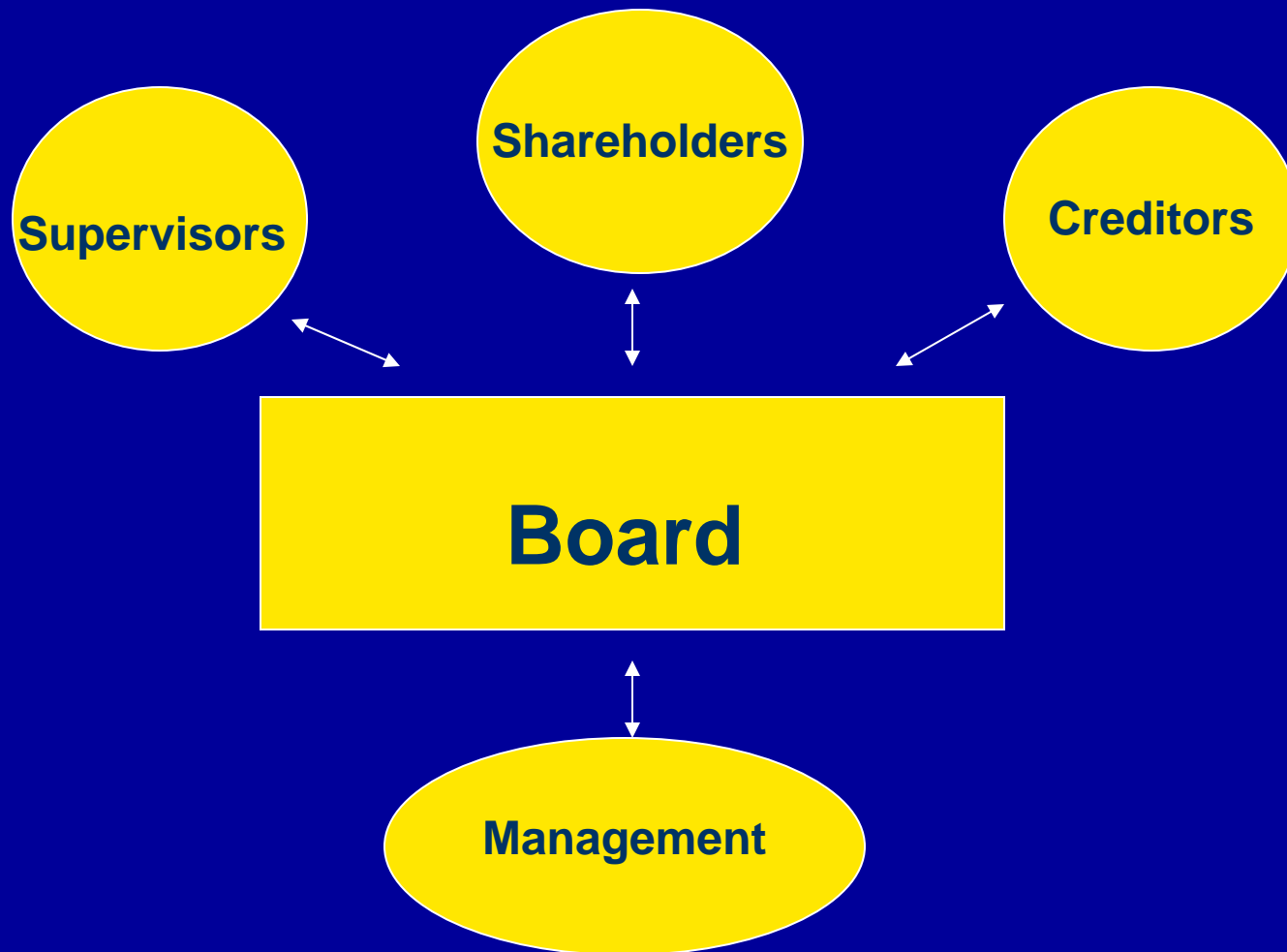
Luigi Passamonti
The World Bank
Seminar on Corporate Governance
for Senior Management in Financial Institutions in Kuwait
Central Bank of Kuwait
15-16 November 2005

The Kuwaiti Financial Sector Context

- Financial Assets > 200% GDP
- Market Capitalization > 100% GDP
- Almost 100 Financial Institutions Boards
 - 10 banks
 - 17 insurance companies
 - 71 investment companies
- Conventional and Islamic Finance

➤ **Board directors have a SPECIAL responsibility for the country's prosperity**

The Board's Positioning



How Should Directors See Their Role?

1. Understand their fiduciary responsibilities vis-à-vis shareholders

2. Understand how bank supervisors look at financial stability

3. Pay attention to market signals

4. Define their engagement with management

Responsibility to Shareholders

- To deliver sustained valuation growth through judicious management of business opportunities, respecting all stakeholders
- Particularly important in financial sector, given its allocative functions of savings to promising investment opportunities
- Extending access to financial products to broader segments of the population

Responsibility To Shareholders (2)

- International Standard
 - OECD Principles of Corporate Governance (CG)
- Main Principles
 - CG should ensure effective monitoring of management by board
 - *“Board should be able to exercise objective independent judgment on corporate affairs”*
 - CG should promote transparent and efficient markets
 - It should protect and facilitate the exercise of shareholders’ rights
 - Including minority and foreign shareholders

How Should Directors See Their Role?

1. Understand their fiduciary responsibilities vis-à-vis shareholders

2. Understand how bank supervisors look at financial stability

3. Pay attention to market signals

4. Define their engagement with management

The Supervisory Perspective

- Risk management considerations are central in today's financial stability architecture
 - Internal governance is a key regulatory aspect
- Board understanding of and involvement in risk management is key to supervisors' validation of risk models

The Supervisory Lenses

- International Standard
 - Basel Core Principles for Bank Supervision
- Most Relevant Principles
 - **#13**: Bank supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board oversight)
 - **#7**: An essential part is the independent evaluation of policies and procedures related to granting of loans and the ongoing management of loan portfolio

The Supervisory Lenses (2)

- Other Relevant Principles
 - #8: Loan Evaluation and Loan Loss Provisions
 - #9: Large Exposure Limits
 - #10: Connected Lending
 - #12: Market Risks
 - #14: Internal Control and Audit
 - #15: Money Laundering

➤ Board Is Main Supervisor Interface For Compliance

Board Assessment Framework

- Following are key parameters used by WB staff when assessing bank board effectiveness
 1. *The Board must have clear, well defined and understood roles and responsibilities, including responsibility to set the bank's strategic direction, oversee management processes and take ultimate responsibility for the prudent operation of the bank.*
 - *Senior management should implement the strategies and policies decided by the board.*

Board Assessment Framework (2)

2. *The Board should assure that effective internal review functions, which are independent, are established for (a) risk management, (b) compliance and (c) internal audit.*
3. *The Board should ensure that stakeholders receive sufficient information on the financial position, structure and objectives of the bank with which to judge management effectiveness.*

How Should Directors See Their Role?

1. Understand their fiduciary responsibilities vis-à-vis shareholders
2. Understand how bank supervisors look at financial stability

3. Pay attention to market signals

4. Define their engagement with management

Market Discipline

- *“Market prices are a powerful mechanism to summarise information about relative risk/return profiles. Market forces can raise the cost or restrict the volume of funding for unattractive activities. Together with the ultimate threat of the demise of the enterprise, these mechanisms can deter risk-taking”* .
- Andrew Crockett, (Fmr) BIS General Manager
- Market actions support Board members oversight activities in relation to bank's risk profile
- Basel II has recognized this contribution through Pillar #3

Market Discipline: Creditor and Board Interaction

- Creditor actions: instrument, not goal
 - Quantity and price changes should prompt management to cut back risk exposure
 - But management may lack incentives for quick action
- Board of directors must lead risk re-alignment
 - In response to market signals
 - To protect shareholders' franchise value
- Supervisors step up vigilance on market signals
 - Enforcement helped by board effectiveness

Why Market Discipline?

- Supervisor not alone to spot risky bank behavior
 - Markets always ahead of regulations
 - Setting measured expectations for public role
- Investor watch = “Thousands of Eyes”
 - Continuous aggregate processing of information
- Fostering investor responsibility
 - Limiting moral hazard

How Should Directors See Their Role?

1. Understand their fiduciary responsibilities vis-à-vis shareholders
2. Understand how bank supervisors look at financial stability
3. Pay attention to market signals
4. Define their engagement with management

Are These Perspectives Irreconcilable?



Board Relationship with Management

- Key aspect for fulfilling its oversight responsibility to shareholders, supervisors and creditors
 - Without informational benefit of executive powers
- Requires clear demarcation between matters requiring Board involvement and those delegated to management
- Built on robust processes and functional skills
 - Board must be capable to keep management accountable

A “Good Practice” Reference

- *“The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed”.*
- *“Non-executive directors should constructively challenge and contribute to the development of strategy”.*
- *“They should satisfy themselves that financial information is accurate and that systems of risk management are robust and defensible”.*

-The Higgs Report on Role and Effectiveness of Non-Executive Directors, 2003

The Key Platform: Board Agenda

Active Role

- Strategy Setting
- Key Business and Risk Management Decisions
- Interface with Internal Control Functions and Bank Supervision
- Keeping the Pulse of Management and Staff Views

Oversight Role

- Strategy Monitoring
- Comprehensive Risk Assessment
- Review of Risk Management Actions
- Review of Market Conditions
- Review of Risk Parameters

Business Review Objectives

Risks? Growth?

Quarterly Reviews

Key Objectives:

- Assess risk appetite, business propositions and boundaries by assessing:
 - risk profile
 - performance
 - internal and external business environment and risk implications

Contents:

- Summary market risk
- Detailed credit, liquidity and operational risk
- Trend analyses
- Business and market outlook

Semi-Annual Reviews

Key Objectives:

- Promote shareholder value creation by evaluating:
 - capital/resource allocation decisions
 - earnings reliability and sustainability
 - short and long term business opportunities and their risks

Contents:

- Summary of all business and customer risks
- Risk-adjusted performance measurement
- Trend analyses
- Business and market outlook
- Status of key initiatives

Board Composition and Skills Matter

- Non-Executive Chairman
- Majority of Non-Executive Directors
 - Independent to protect minority shareholders
- High Integrity and Sound Business Judgment
 - To command management's respect
- Financial Skills and Prudence
 - To become trustworthy partners of bank supervisors

The Private-Public Intersection

- A strong board is a common goal for investors and regulators alike
 - Board effectiveness should be “Pillar O” of any prudential framework
 - It will take time to gain experience to assess its direct contribution to financial stability
 - Strong board oversight facilitates investors’ risk diversification strategies as “home bias” wanes

Common Benefits, Together

Private Commitment

- Shareholders to appoint non-executive directors capable to
 - Challenge management
 - Understand finance complexities
 - Engage with supervisors
- Directors to understand public policy objectives
 - Other investors, beyond shareholders

Public Commitment

- Supervisors to help Boards discharge their duties
 - Sharing their analytical tools and perspectives
 - Promoting good practices through benchmarking
- Supervisors to be unforgiving on Board lapses
 - Rotation of weak directors

With A Single Shared Goal: Stronger Self-Discipline