CORPORATE GOVERNANCE

Teeth, not lip service

by Andrew Cunningham
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GOOD corporate governance, like many of the new trends in financial markets over the last 10 years, was supposed to reduce risk in financial institutions, ensure stable profits and eliminate abuse and corruption.

And yet, just as it has turned out that securitisation did not result in a dispersion of risk, and complex financial models were not always able to price financial products accurately, it also transpires that a proliferation of corporate governance codes failed to deliver on its objectives. The emergence of a whole industry dedicated to corporate governance was not able to prevent lapses of oversight and failures of control – with devastating consequences.

Board risk committees clearly did not understand the complex financial instruments which began to occupy a larger and larger proportion of their institution's risk profile. Remuneration committees set up compensation schemes which allowed senior managers to reap vast bonuses for generating ephemeral profits. Indeed, the origins of the financial crisis lie in the simplest of internal control failures – extending loans without proper credit checks or verification of collateral.

Many of the financial institutions which have suffered huge losses over the last year had well-established governance procedures which they clearly believed were effective.

Washington Mutual's regulatory filing for 2007 stated that: "The board of directors, assisted by the audit and finance committees on certain delegated matters, oversees the monitoring and controlling of significant risk exposures, including the policies governing risk management." In September 2008, the bank was sold to JP Morgan after mounting losses on mortgage loans led depositors to withdraw $17 billion over a 10-day period.

Every aspect of the way financial institutions are operated is now under scrutiny. As part of this process, we need to reassess the effectiveness and key principles of corporate governance for financial institutions. We should start by recognising the limits of corporate governance.

If a board meets six times a year, how much oversight can the directors really exercise over the bank's business? Even when less formal interaction between senior managers and board members is taken into account, the fact remains that only the management will have a detailed appreciation of all aspects of a financial institution's business.

As we re-think what we can expect from corporate governance, there are three key areas to focus on.

First, it is reasonable to expect the board to take a view on major shifts in a bank's strategy and risk profile. When a bank's exposure to structured financial instruments – whether held on or off the balance sheet – moves from a few billion to a few hundred billion dollars over a relatively short period of time, the directors need to recognise that they are overseeing a very different institution. In some cases, the appropriate conclusion may be that – whatever the institution's regulatory and legal status – they are now overseeing a hedge fund or an investment company, rather than a commercial bank.

Secondly, some board members need to have detailed technical knowledge of how the latest financial products are structured and priced. In simple terms, one or two board members are going to need to have PhDs in mathematics – and not PhDs which were awarded in the 1960s.

Thirdly, board members need to test for themselves the institution's controls and risk culture. They should walk around the offices, unchaperoned by senior managers, and speak to junior staff about how they do their work. They need to do this again and again, over a period of years, to get a feel for how the institution is changing.

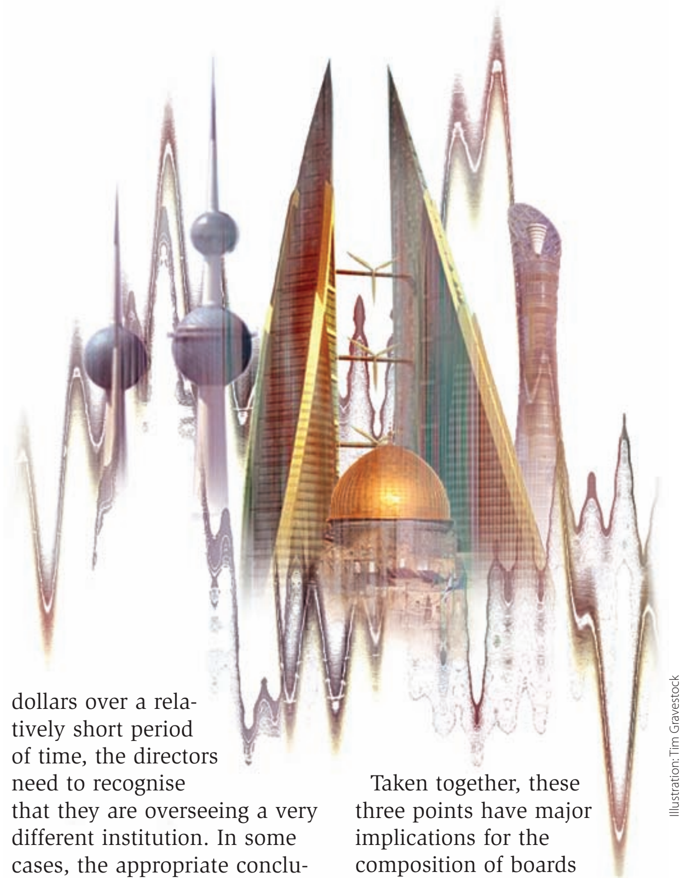

Illustration: Tim Gravestock

Taken together, these three points have major implications for the composition of boards of financial institutions in the Gulf. Historically, these boards have been filled with a combination of patriarchs from local trading families and mid-ranking members of the royal family.

An encyclopedic knowledge of local trading families may be a useful adjunct to the bank's credit appraisal skills, but it does not help the bank survive a meltdown in the price of its credit default swaps. Financial institutions in the Gulf are going to have to bring younger, more technically savvy directors onto their boards. Financial markets in the Gulf are changing rapidly. Likewise, corporate governance must evolve and change at an equally rapid pace. ■

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