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VIEWPOINT LAJOS BOKROS AND LUIGI PASSAMONTI

How to export risk management

Effective corporate governance is vital for banks operating in emerging markets

Corporate governance is not a matter for Wall Street alone. A good board is as important to shareholders running the business as lawyers and financial advisers are when closing an acquisition.

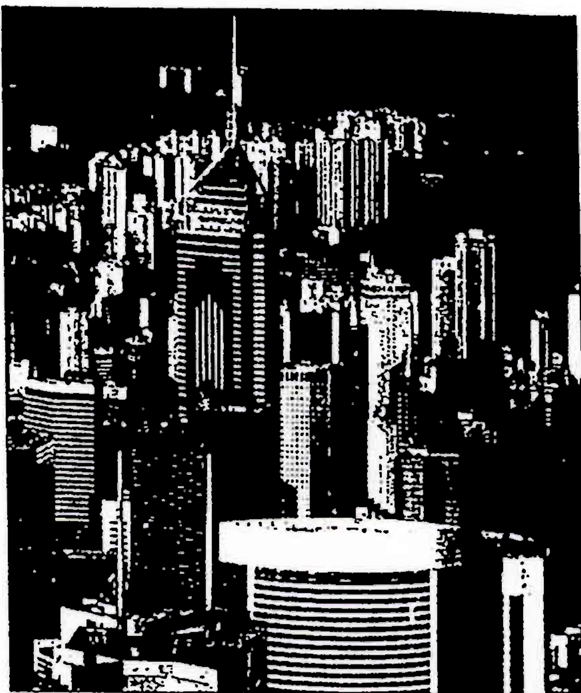
Among banks that operate in emerging markets, effective corporate governance is essential. Such banks are vital to economic development, running national payment systems and providing financial services to the economy, often backed by public deposit guarantee schemes. And their role is becoming increasingly important. With the stock of equity investments in developing countries reaching $70bn, global banks have doubled their market share to 40 per cent in 61 of the poorest countries over the past five years.

Yet the banks' corporate governance practices in emerging markets are inadequate to cope with increasing risks. There are three reasons for this.

First, institutional investors have not zeroed in. While global banks practise sound corporate governance at home, they have postponed the adoption of similar arrangements abroad because of lack of detailed investor scrutiny. In central Europe a rare exception is, for instance, Société Générale, whose governance model draws on the head office standard. With a firm grip on the management team or board, its local affiliate boards have a strong majority of non-executive directors, several of them independent.

Second, banking regulations have not kept pace with recent corporate governance advances. Issues such as board composition are sparsely discussed in domestic banking legislation. While the Basle Committee on Banking Supervision says non-executive directors have to be represented on boards and that "qualified external directors can provide useful expertise in times of corporate stress", it does not refer to independence from large shareholders.

Nevertheless, influenced by the Asia crisis, the banking authorities of Hong Kong and Singapore have started elaborating on the issue of effective board scrutiny of management.



Overview: Hong Kong is looking at board scrutiny Sarah Murray

Third, majority shareholders may have overestimated their ability to govern in culturally challenging environments. While the recent debate on corporate governance centres on "outsiders" versus "insiders", even a dominant shareholder can be an outsider. In developing countries local management cannot be easily replaced and its reputation may not suffer when and if it is eventually removed.

As global banks shift more capital to support faster-growing operations in developing countries, they should take the opportunity to strengthen governance of their local operations.

One option is to appoint more independent non-executive directors on foreign boards. Non-executive and independent directors (preferably reputable bankers) can play a critical role, particularly in markets plagued by volatility, poor financial disclosure and weak creditor rights. Their arm's-length position from shareholders and management enables them to:

- Help shareholders assess how activities are conducted, including the parent's management assistance programme, and where potential risks lie;
- Send tough messages to the management team, especially when the majority shareholder provides extensive management assistance;
- Help resolve conflicts, sometimes exacerbated by cultural barriers, where other directors might be less effective;
- Make management accountable without using precious direct shareholder authority.

Banks should consider appointing head office executives to management boards or executive sub-committees, since their appointment to local supervisory boards can weaken the governance structure. Indeed, the representation of head office executives on supervisory boards can be compared with a family-owned and managed company: management has *carte blanche* to supervise the business it operates.

Financial authorities, the custodians of market stability, also have a role in ensuring the effective functioning of the governing bodies of financial institutions. Such authorities should ensure boards are directly accountable to them through regular reviews of their specific activities. Authorities should also assess whether the management duties of board members weaken their supervisory effectiveness. Broad adoption of Organisation for Economic Co-operation and Development corporate governance principles in domestic banking legislation could be a step in the right direction. Authorities should remove administrative barriers that prevent majority shareholders from actively managing their affiliates. Banking legislation sometimes makes it unfeasible for foreign shareholders to appoint their executives to the management ranks of local affiliates. Authorities should also improve the credit information infrastructure. Adequate data availability is a prerequisite for effective scrutiny and risk containment. Banking-unfriendly privacy laws and lack of credit bureaux impede effective credit management processes in many developing countries.

The running of far-flung foreign operations, often at a large cultural and institutional distance from the domestic base, requires strong governance. But it will not improve until institutional investors make the issue of how global banks run their foreign affiliates a regular and prominent feature of their interactions with senior management.

Governance can be provided either by full management integration or by strong independent scrutiny of management activities. In the former case, Citigroup, with its strong, hands-on management culture, has taken the lead by further integrating the control processes of its emerging markets activities in its head office platform. Given the current sensitivity to risk management, even banks with a federalist philosophy will move fast by appointing a majority of independent non-executive directors to their foreign boards.

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