

Non-Executive Directors: *A Private-Public Resource*

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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 Business Perspective

- Effectiveness of non-executive directors became an urgent business issue as investors, creditors and other stakeholders were hit by unchecked management actions
- A reputable and expert presence close to management gives comfort to investors
 - To check management acts in their interest
 - To counsel management
 - To keep management honest

The Regulatory Perspective (Finance)

- Internal governance is a key regulatory aspect
 - Risk management considerations are central in today's financial stability architecture
 - Tailored to the specific needs of each institution
 - Adapted to changing circumstances
- Board understanding of and involvement in risk management is key to supervisors' validation of risk models and management procedures

Public Action Has Not Always Fostered Private Responsibility

- Supervisors engage mainly with management
 - A convenient shortcut into bank operations
 - Acknowledging Boards' weaknesses?
 - But undermining private monitoring
- Another example of an unintended distortionary effect of some supervisory policies
 - E.g., forbearance, loan classification, provisioning
- Unless placed in a market-friendly environment
 - Competition, disclosure, exit, corporate control provide a framework for less costly disciplining options

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
- How to pursue a single strategy for common benefits?

How To Build Common Benefits?

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

Islamic Finance Relevance

- Entrepreneurial support of productive activities creates special risks for Islamic financial institutions
 - Only partially mitigated by pass-through funding structures
- “Caveat emptor” considerations for investment account holders not in line with Islamic principles
- Endogenous checks-and-balances are critical for continued industry growth
 - Limits of supervisory intervention in client-specific highly-structured risk-sharing transactions
 - Otherwise, could you imagine complexity of designing Pillars 1 & 2 adjusted to a private equity-like industry?

The Challenges of IF Growth

- The calibration of appropriate checks-and-balances is a significant policy challenge as Islamic finance continues to grow
 - It is unsafe to assume that evolving regulatory policies and supervisory practices will always continue to keep neck-to-neck with market innovation
- A forceful call on market discipline and shareholder monitoring is essential
 - The scale of the challenge, coordination problems, and potential consequences of failure make it a priority
 - A strong reference in tomorrow's Press Release?

Why A Private-Public Perspective?

- Investors expect new levels of professional performance of non-executive directors now
 - Also to serve on Board functional committees
 - Future build-up of Board professional skills
- Market conditions are now favorable, if financial authorities wish to enhance Board work
 - Significant contribution to market discipline if board work became quasi-extension of supervision work
 - Essential for sustainable Islamic finance growth

Upgraded Board Monitoring

Suggestions For Authorities

- Make fit-and-proper test of non-executive directors a central feature in licensing
 - Err on the side of caution
- Recognize Board as main supervisory focus
- Make Board reporting of its risk management activities mandatory
 - With incentives for enhanced disclosure
- Help non-executive directors with enhanced technical training
 - It is a “public good” investment, as supervision