ISSUES

PACIFIC ECONOMIC COOPERATION COUNCIL

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Strengthening Domestic Financial Systems in APEC:

PECC Scorecard Initiative for Tracking Progress in Improving Corporate Governance Practices in Banks

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About this Issue

This **ISSUES@PECC** summarizes the findings from the discussion on *The Unfinished Business of Strengthening the Domestic Financial Systems: How Much Unfinished and How to Help Finish,* at the 3rd Annual Conference of the PECC Finance Forum held in Santiago, Chile, on June 20-21, 2004.

The PECC Finance Forum serves as an open forum for a tri-partite dialogue among the academia, government and business sector, on the financial policy issues facing the Asia-Pacific region. The purpose of the dialogue is to assess the international environment for financial stability and development in the region, the progress in the promotion of financial reforms, integration and cooperation in the region, and to develop the desired vision of regional financial and monetary cooperation. For the purpose of these assessments, the Finance Forum undertakes survey-based task force studies on specific issues as well as convenes an annual conference of experts drawn from the member economies and international financial institutions.

For more information, visit www.pecc.org/finance.

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The Pacific Economic Cooperation Council (PECC) was founded in 1980 to serve as a forum to discuss cooperation and policy coordination in the Pacific Region. PECC's expert networks composed of analysts, officials and businessmen provide practical policy advice on trade, finance, and sectoral issues to the region's governments. PECC is the only non-government official observer of the APEC process. See: http://www.pecc.org for more details.

INTRODUCTION

Between the US and the UK on one hand and many other economies---especially the developing ones in East Asia---on the other hand, there is a vital structural difference that suggests a different emphasis in pursuing corporate governance improvement programs. That difference lies in the relative importance of either the capital market or the banking sector in providing external corporate finance. In the US and the UK, capital markets are more important; but in many East Asian economies, particularly the developing ones in the region, the banking sector is predominantly more important.

Understandably, corporate governance improvement programs in the US and the UK need to be pursued through the stock exchanges. Listing rules, reporting requirements for publicly listed companies, and SEC rulings have been and continue to be of great importance. These too are important in other less developed economies. But of greater importance are the circulars that come from banking regulators, specifically the Central Banks. Since banks play a much more significant role in the financial system, and since under the BIS rules on capital adequacy banks have to give a more systematic risk assessment of their asset portfolio (where corporate governance practices of borrowing companies can help determine risks), corporate governance improvement, on a priority basis, needs to be pursued in and through the banking sector.

It is understandable, therefore, that in many developing economies in East Asia, Central Banks have started to require corporate governance orientation seminars of all bank directors. In some economic jurisdictions, they have imposed attendance at such orientation seminars on corporate governance as a crucial part of the "fit and proper test" for bank directors. Those bank directors who have complied with the attendance requirement may continue to serve in a bank board; and those that have not, as of a certain date, face the prospect of being disqualified from serving as a bank director.

While this training requirement may be viewed as an important signal for the priority that bank regulators give to improved corporate governance practices, it clearly is not a guarantee that in fact corporate governance practices in the bank sector would immediately take a turn for the better. Much more needs to be done.

CORPORATE GOVERNANCE SCORECARD

In fact much more can be done by providing the banks and bank regulators with a tool for tracking actual progress in improving corporate governance practices. That tracking tool may well be the corporate governance scorecard that is being forged in several APEC economies, particularly in East Asia.

The scorecard can be forged by making a reference to a set of proper corporate governance practices. APEC Finance Ministers had adopted this set of proper practices in Shanghai in 2001. The APEC Leaders subsequently endorsed those practices (also in Shanghai in 2001). With such adoption and endorsement, APEC economies are free to use them as reference points, indicating what the proper practices are and setting them as targets to be eventually met according to timetables they choose.

In the case of banks, especially in those economic jurisdictions where bank directors have already been required to take an orientation seminar on corporate governance, they know what the reference points and proper practices are. They should then be able to relate and compare their current and actual corporate governance practices with those reference points. Any gaps would point them to a time-bound program of aligning the latter (their actual practices) with the former (the APEC-adopted proper practices). And the scorecard would simply help them (and their regulators) track the progress they actually make over time.

In the APEC area, banks already have a framework for the initial scorecard on corporate governance by simply referring to the APEC-adopted set of proper corporate governance practices. In addition, due to the strategic importance of banks, proper practices on Board Committees---such as those already required, e.g. Audit Committee, Risk Oversight Committee, and Governance Committee (with responsibility for various Directors' issues such as nomination, continuing education, performance evaluation, and remuneration)---may also be added in the coverage of the scorecard. The culture of compliance, ethics and social responsibility, with specific application to banks, may also be covered. Thus, the coverage can and should be broadened to make any corporate governance scorecard for banks as appropriate as the bank regulatory environment may demand, especially in view of the BIS agreements. In this regard, it is necessary for work under APEC auspices to agree on a framework of additional proper corporate governance practices (on top of those already adopted) with special relevance to banks. As in the previous instance, PECC can do the spadework in this regard.

The framework of proper practices would provide the questions and items to be included in the scorecard.

Questions do have to be answered, however. Here, there are options, which may be taken one at a time in every economic jurisdiction. Over time, for greater objectivity, it may be necessary to suggest that all options are considered and eventually taken. These are:

a) The self-assessment option. This is best taken in connection with the training that may be required of bank directors. After proper practices are explained and fully discussed, bank directors are asked to assess their current practices relative to the standards that the adopted proper practices have set out.

b) The cross-check from the bank regulator option. Increasingly, Central Bank examiners may include an assessment of corporate governance practices in the banks they examine, using the adopted proper practices as the benchmarks.

c) The cross-check from an independent Institute of Directors option. In several economic jurisdictions, independent Institutes of Directors have already been established. These are in process of equipping themselves and cooperating with each other in coming out with corporate governance scores of banks and other public corporations.

For as long as the framework in all these options is broadly similar, and for as long as the weights they assign to various items included in the scorecard are broadly comparable, then it is possible to work towards broadly consistent scores over time, across banks and public corporations, and even across economies.

As with all initiatives in APEC, each economy is free to go at the pace it chooses and to take any options at the time it chooses. However, cooperation and coordination towards adopting a broadly similar framework and with operational parameters of that framework also worked out on a broadly similar basis, could eventually lead to some convergence. Over time, it may even be possible to make some comparison of the different corporate governance scores---at least of banks---in the APEC area, starting possibly with the economies in East Asia. Given the strategic importance of banks in many economies, the scorecard may also be used as a prod to improve corporate governance practices in borrowing corporations that depend heavily upon banks for their external corporate finance.

It is in this light that it is recommended that work on developing a common tracking tool for monitoring actual improvement in corporate governance practices---in banks and through the banks---should be encouraged in the APEC area. The economies in East Asia may wish to take the lead once again. And PECC is once again contributing towards making significant progress in this initiative.

A coalition of the willing, drawn mainly from East Asian economies, has been formed under PECC auspices. It will focus on developing---on a cooperative and voluntary basis---a corporate governance scorecard for banks. The coverage of proper corporate governance practices needs to be expanded beyond those that have already been adopted in APEC so as to make them much more relevant for banks. Common weights to assign to each item included also need to be agreed upon. And a consensus shall be forged on the modalities for moving from one option to the next until all three options are considered and taken on a voluntary basis.

PECC proposes to present the initial results of this corporate governance scorecard initiative for banks in 2005 during the Korean chairmanship of APEC.

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