

# 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