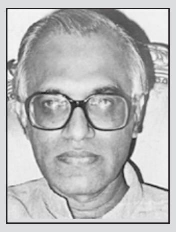
Corporate governance and auditing standards



WAHIDUDDIN MAHMUD

ECONOMISTS are not known to be good at practical matters of financial markets. True that David Ricardo, the foremost classical economist, was a stockbroker, and Lord Maynard Keynes made a fortune in the stock market. More recently, Robert Merton and Myron Scholes won the 1997 economics Nobel Prize for deriving a model for assessing risks in stock market trading. They then proceeded to have a partnership business in a hedge fund involved in derivative trading that eventually suffered a trading loss of $3.5 billion! Then came the East Asian financial crisis, which made economists suddenly realise that the pro-market reforms they advocated had to cope with a market of a different kind -- in Wall Street and the City of London.

On one thing, however, economists will all agree: that reforming the financial sector is undoubtedly one of the crucial prerequisites of embarking upon a path of efficient, market-oriented economic growth. At the heart of such a growth process lies the allocation of resources by linking savings to investment. By performing this essential task, financial markets work as the "brain" of the economic system, the central locus of decision making. If they fail, not only will the sector's profit be lower, but, more importantly, the performance of the entire economic system will be impaired.

Bangladesh has come a long way in implementing market-oriented reforms including in the financial sector. As economic liberalisation replaces rigid control, a new more marketed-oriented, but more sophisticated, kind of economic and commercial regulatory framework needs to be put in place. In the financial sector in particular, there needs to be a delicate balance between regulation and entrepreneurial freedom. Much of the present malaise in our financial sector can be attributed to the fact that we went for liberalisation without providing for adequate regulation and supervision. The country's nascent stock market was greatly damaged by the end-1996 episode of phenomenal boom and bust; it was mainly created by the machinations of some unscrupulous share-traders who took advantage of the laxity in regulation.

In commercial banking, interest rate deregulation along with the setting up of banks in the private sector has not led to the desired result from market competition. The spread between the average deposit and lending rates of interest, currently as high as about 7 percent, has, if anything, increased instead of decreasing. This high interest rate spread is explained by the high rates of loan default, which raises the cost of financial intermediation, while the relatively efficient private banks, including the foreign ones, can reap excess profits. In order to attract deposits, some private banks are increasing their rates of interest on deposits, which in turn make them lend to high-risk borrowers at higher lending rates, thus jeopardising the long-term financial health of those banks. Market competition provides, at best, limited discipline. The East Asian experience shows that a mildly positive rate of interest on deposits in real terms (that is, after accounting for inflation) is good for economic growth, but high lending rates of interest are not. It is worth mentioning that in the West European industrialised countries, interest rate regulation in some form or another existed even as late as the early 1980s.

The nationalised commercial banks are burdened with huge problems requiring fundamental structural reforms. Their management is weak, corruption and fraudulent practices are rampant, the quality of staff is extremely poor, they are burdened with huge excess manpower and there is undue political and trade union influence vitiating their entire management culture. The problems of the private banks are of a different nature. Their main problem has been the large-scale "insider lending", with some sponsor-directors simply plundering away depositors' money. It is only after the central bank could enforce some measure of regulation on the behaviour of the sponsor-directors that the loan default rates in the private banks started to generally improve. So far, Bangladesh Bank has successfully contested in court to remove as many as 53 bank directors for being loan defaulters and eight others for indulging in other improper practices. Many of these directors even refuse to comply with the regulation that their defaulted loans be adjusted against their shares held with the banks.

Although the private banks now account for nearly a half of the country's banking business, the state-owned banks still play the major role in rural banking and in providing term loans for industrial investment. In our financial system, there is a "missing middle" between microcredit and formal banking, so that small enterprises are the most credit-starved part of our economy. In respect of term lending, the banking sector generally suffers from weaknesses in investment appraisal capability. These are difficult problems with no readymade solutions, and we need to have a road map to address them.

The stock market can be a source of investment finance and there is undoubtedly a need for reviving it. I do not however share the belief held by many that the stock market can and should replace commercial banking as the major source for raising funds for investment. It has rarely happened elsewhere. In the developed industrialised countries, only a negligible fraction of investment funds are raised from new equity or bond issues. The stock markets there resemble more like a gambling casino where individuals trade in risks. Even in the emerging economies, such as those in East Asia, bonds and equity have accounted for a lower share of investment finance, compared to both profit retention and bank finance. Nevertheless, in a newly industrialising country, a vigorous, well-regulated stock market can play an important role in raising investment funds both domestically and from abroad.

Very recently, the government has taken a number of important regulatory measures in further consolidating the financial sector reforms. These measures are to do with strengthening the legal procedures for loan recovery, rationalising the criteria for loan rescheduling particularly to discourage habitual loan defaulters, facilitating the cleaning up of the banks' balance sheets through loan write-offs, beefing up the capital base of the banks, and taking measures towards making the bank boards more accountable and competent. The boldness of these reforms has taken many by surprise. It should be realised that the strength of these reforms lie in their being based on home-grown ideas based on a realistic assessment of our own circumstances. We should view this reform process as a continuing, evolving one -- a learning-by-doing exercise, where further modifications can always be made if need be.

A "fit and proper test" has been introduced for qualifying to be a bank director. In fact, most countries impose restrictions on who can own a bank, so as to ensure that the owner-director should have a minimum level of expertise and should not be a person who has a record of abusing trust. Unfortunately, political affiliation rather than the professional track record of sponsor-directors has often been the criterion for granting permission to open new banks.

The minimum required paid-up capital of a bank has been raised from Taka 20 crore to Taka 100 crore (the comparable figure for Pakistan, for example, being Rupee 100 crore). The logic of such a measure along with ensuring capital adequacy is not often well understood. In addition to other regulatory measures, it is a means of indirectly influencing the incentives or motivations of owner-directors. The larger are their investments in the bank, the higher are their stakes in seeing that the bank is run profitably. Consequently, they will be less tempted to secure personal gains to the detriment of the bank's interest or even to plunder their own bank as some of them have done in the past.

As for the recently introduced regulations regarding the size of the bank boards and the length of tenure of the directors, let me make a general comment. I agree that there should not be too abrupt changes and that any transition process should be a smooth one. At the same time, owner-directors should have no legitimate interest in the running of their bank except to ensure that they get fair returns from their investments. It is, therefore, in their own interest to see that the bank directors are competent enough to carry out their responsibility. How can having sons and daughters and daughters-in-law on the board, irrespective of their expertise, serve that purpose, unless there are some hidden agenda? Public companies should not be looked upon as family businesses, more so in the case of banking companies where the depositors' interests are involved. In a recent survey of bank regulation in more than one hundred countries, in 80 to 90 percent of the cases, the regulatory authorities are found to have wide-ranging powers regarding bank restructuring and reorganisation, including the removal and replacement of management and directors and superseding of shareholder rights (*Papers on Financial Services*, Brookings Institution Press, 2001).

The market economy, particularly the financial markets, cannot function without trust -- trust that contracts will be honoured and that the money lent by one party to another will not be stolen or diverted to illegal purposes. The incredible accounting frauds involving the US corporate giants like Enron and WorldCom that led to the loss of billions of dollars worth of investments by ordinary shareholders revealed the ethical bankruptcy of a large part of corporate America. This is a reminder that bookkeeping is not merely a numerical exercise -- that the auditors and accountants must be alert in detecting the red ink on the moral balance sheets as well.

Auditing standards are crucial to improving corporate governance, whatever reforms in the regulatory framework may be introduced. Sound accounting practices are needed not only to ensure compliance to regulation but also to accurately assess the net worth of banks; since if the true net worth is negative, the government may be left holding the bag in the event of bank closure. The Institute of Chartered Accountants in Bangladesh (ICAB) deserves credit for its efforts in raising the accounting and auditing standards in Bangladesh by adopting the international standards. The ICAB may now consider taking steps, through legal provisions and professional self-disciplinary measures, to ensure mandatory compliance of the adopted standards by all its members. This may require, among other things, amending the Bangladesh Chartered Accountants By-laws 1973.

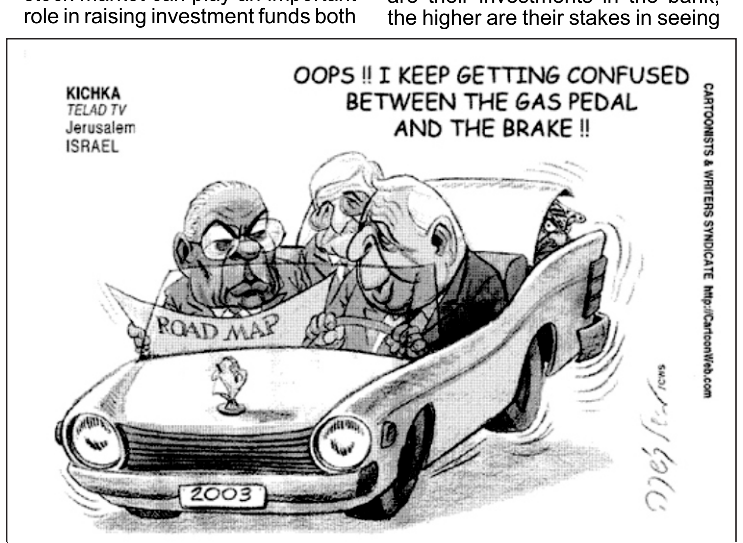
Global experience shows that mere transplanting of standards from outside will not produce the desired outcomes unless steps are taken to address the fundamental weaknesses of corporate governance. Much depends on the structure of incentives regarding financial reporting and disclosure. To get decent data, there must be a demand for it among creditors, managers, investors, and others who act on the basis of accounting information and a reliable means of penalising those who make fraudulent disclosures. For example, if corporate businesses are run as family-owned firms, the informal "insider" information will tend to displace the demand for arm's-length, objectively verifiable financial disclosure.

Reliable external auditing is supposed to be the main vehicle of independent oversight on management by the company boards. The owner-directors of banks should therefore demand such auditing in their own interest for the sake of transparency, unless they have things to hide. It seems curious that some bank boards have been rather negligent in ensuring a sound system of internal and external auditing in their banks. Bangladesh Bank has already made it mandatory for banks to follow international auditing standards. Suggestions have now been made to make such auditing even more rigorous, particularly in providing more in-depth information regarding financial risks and in revealing the so-called "related party transactions" (that is, transactions with entities in which bank directors have an interest).

It has also been suggested that the audited reports of the banks need to be more widely publicised and that the financial fundamentals of the banks in a capsular form may be displayed in every bank branch. Surely, the public has a right to know where their deposits are safe, since only up to one lakh taka of deposits are currently insured. This will help a healthy competition, since the banks will be able to attract deposits on the basis of their established reputation -- as some foreign banks do -- instead of having to engage in a warfare of bidding up the rates of interest on deposits.

Lastly, I should emphasise the role of moral and ethical standards of behaviour in corporate governance. The market economy, particularly the financial markets, cannot function without trust -- trust that contracts will be honoured and that the money lent by one party to another will not be stolen or diverted to illegal purposes. The incredible accounting frauds involving the US corporate giants like Enron and WorldCom that led to the loss of billions of dollars worth of investments by ordinary shareholders revealed the ethical bankruptcy of a large part of corporate America. This is a reminder that bookkeeping is not merely a numerical exercise -- that the auditors and accountants must be alert in detecting the red ink on the moral balance sheets as well. Let our accounting profession not share the blame that is attributed to economists: that they know the price of everything and the value of nothing.

Wahiduddin Mahmud is Professor of Economics, University of Dhaka. The article is based on his keynote address at the 30th Foundation Anniversary of The Institute of Chartered Accountants of Bangladesh (ICAB), May 27, 2003



MUHAMMAD HABIBUR RAHMAN

Do not build a cage for a man

If you want to build a cage for a squirrel
Build it around a big tree in a chaparral.
The squirrel must swirl, twirl and whirl .

To make the squirrel feel happy and free
At least five holes must be there in the tree
So that it may play hide and seek.
Do not build a cubbyhole for the squirrel meek.

The man is supposed to have come of age
For him it would be preposterous to build a cage.
The poor guy! He is already in a squirrel cage.
Whether in the Andamans and Nicober Islands ,
The St. Helena or the Robben Island
Or at the Guantanamo base
Or somewhere in similar other place
If you intend to build for him a cage,
For him that would be a great outrage.
He may gape and snarl at you in rage.
He may pine, peak and languish
And in sorrow, angst and anguish ,
He may ape mockingly.
Whether he would try shockingly
A little tail to grow,
Believe me! That I do not know.

Muhammad Habibur Rahman is former Chief Justice and head of caretaker government.

Japan's Aceh dilemma

MONZURUL HUQ *writes from Tokyo*

JAPAN in recent days is increasingly showing keen interest to help Asian developing countries to sort out political problems that are posing serious threat to their development process. The policy makers in Tokyo have even coined a lucrative term for such a new initiative that they call 'peace dividend'. The main idea behind this new terminology lies in the understanding that solving political problems would eventually help troubled nations to move smoothly towards their development goals, which would eventually bring prosperity to countries and their people. The leading proponent of such new Japanese initiative is a former UN bureaucrat, Yasushi Akashi, who, as the UN representative in Cambodia in early 1990s played a crucial role in helping the country to find an accepted solution to the long running civil war and thus gaining his own credibility as an able peace-broker. Akashi thus became the first Japanese national to have an international image as a peacemaker and since then he has been advising the Japanese government on issues related to international conflict, peace, as well as development.

During the last decade Japan for most of the time topped the list of world's donor nations. Tokyo's generous aid budget also brought prestige to the country that still is seen by some of its neighbours as a potential military threat, despite the reality that Japan no longer possesses regular armed forces in real sense.

The last decade of the twentieth century has witnessed significant changes in international politics. The demise and disappearance of Soviet Union paved the way for the emergence of a uni-polar world where the dominating role in international politics shifted firmly to the hands of the only existing superpower. But as the sole superpower quickly got involved in crucial issues of containing the adversaries and maintaining its leading strategic role, this left open few opportunities for other smaller nations to try their hands in mediating conflicts in backward regions.

Norway was first country to avail such opportunity and the country gradually moved out of its conventional role of a donor and started helping a number of conflict-torn backward nations finding solutions to the conflicts they are facing internally. Japan, being a much bigger donor than Norway in terms of total ODA disbursement, soon started to show special interest on the Norwegian pattern of helping the underdeveloped. As Tokyo's ODA policy was coming under serious criticism amid country's continuous economic downturn, the approach also seemed to be a lucrative one to the policy makers. Since then Japan has been involved at least in two regions of conflict where the extent of antagonism has brought much suffering to the ordinary people. But for Japan there still remain a number of stumbling blocks that had to be overcome before the country can establish itself as a peace-broker with a real neutral standing.

Throughout the long cold war period Japan firmly belonged to the Western camp. This no doubt helped the country to achieve tremendous economic success. But the price Tokyo had to pay in other term was losing its identity of neutrality. The end of the Cold War rivalry helped Japan to shred off partially the negative aspects of that earlier image and come out relatively clean in international politics. The timing also coincided with Japan taking the leading role in international development assistance initiatives with an ever-expanding budget that allowed the policy makers in Tokyo to dictate terms to the recipients. But the subsequent development in international politics has once again proved the frailty of that policy as Tokyo's standing on Iraq issue exposed its vulnerability. As Japan now getting ready to send its troops to Iraq on the pretext of helping the nation to rebuild its essential infrastructure when the country is under total control of occupied forces, the position of Japan as a neutral mediator in any negotiation in conflict regions is sure to become questionable.

The two major conflict regions in Asia that Japan got involved in the process of helping the concerned parties find a lasting solution to the problems are Sri Lanka and the Indonesian province of Aceh. As for Sri Lanka, the role of Japan is that of a supportive one as Norway for quite long had been trying to bring the fighting groups to a negotiating table. Japan lately got involved in the process as a principal donor country helping for Sri Lanka and promised lucrative financial assistance for rebuilding the shattered economy once a peace deal is reached. The two sides are still sticking to a ceasefire agreement signed more than a year ago, despite a slow and bumpy progress on major issues that divided the nation.

Aceh, on the other hand, provided Japan with a much broader opportunity to show the world the true face of Japanese government's 'peace dividend' economic aid policy. The only other outsider involved directly in the negotiating process being a non-governmental think tank based in Switzerland, the scope for Japan to exert leadership role was much wider. The government of Japan for quite some time in the past was urging the authorities in Indonesia to solve the Aceh issue in a peaceful manner through dialogue. As part of Tokyo's effort to extend all possible support for achieving that goal, the government of Japan held the preparatory conference on Peace and Reconstruction in Aceh on December 3 last year in Tokyo, and subsequently the government of Indonesia and the Free Aceh Movement (GAM), an armed group aiming for independence of the province, reached an agreement and signed a peace deal in Geneva on December 9. Such early success raised hope among policymakers in Japan that Tokyo might see a real breakthrough in negotiating a final peace deal for Indonesia's troubled region during the next session of dialogue set for on May 17 and 18.

Meanwhile, as the dates for subsequent negotiations in Tokyo was fast approaching, the government of Indonesia started to take tougher standing particularly on demands of the rebels that a clause allowing the province to secede from the federal set up of Indonesia should be included in the draft final agreement that the parties were to sign. On the eve of Tokyo talks, the government of Indonesia suddenly arrested several rebel negotiators putting the whole process in jeopardy. At the same time the Indonesian armed forces, which has already earned international notoriety for its random practice of brutality and widespread violation of human rights norms in East Timor, continued all out preparation for military action in Aceh, giving clear signals that the authorities in Indonesia were not willing to give up their tough stand when delegates meet in Tokyo. As a result Tokyo talks were destined to fail even before they officially took off.

Now, as the Indonesian army is already in full-fledged action against civilian population of Aceh, the clock has probably taken a reverse move running back to late 1970s when the separatists in Aceh started the movement against what they called a repressive regime that had neglected the province in all respect. Any move to restart the failed peace talks, therefore, probably has to start again from the scratch. Whether Japan would be able to hold the key by playing its economic assistance card also remains doubtful, as it would go against Tokyo's economic interest to antagonize Jakarta. Just as was seen in the past concerning East Timor, Aceh would most likely have the similar fate the main players of regional politics either would express direct support for Jakarta, as already been reflected in Australian position on the issue, or at least keep a long silence. Aceh, after all, is rich in its oil resources and Indonesian military machine most likely would tap that resource for those who would be willing to pay in cash.