The role of financial regulatory bodies in investment management

Annual address by Tom Alweendo, Governor of Bank of Namibia

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The Right Honorable Prime Minister
Hon. Ministers and Members of Parliament present,
Members of the Diplomatic Corps
Members of the Board of the Bank of Namibia
Media Representatives
Distinguished Quests,
Ladies and Gentlemen,

At the outset, I would like to extend a very warm welcome to all of you for honoring our invitation to our annual address. This annual event has been organized to serve as a platform for the interaction and sharing of economic information between ourselves, the Bank of Namibia, and you our stakeholders. Tonight, my address will focus primarily on the role of regulatory bodies with respect to investment management undertaken by both the private and public sector institutions.

Before doing that, I would like to share with you some information on the recent economic developments in Namibia. On average, an economic growth of 4.4 percent was recorded from 2000 to 2004. The year 2004 in particular saw a robust performance of the Namibian economy

with a respectable growth of 6 per cent. This was the second highest growth rate recorded over the last five years; the highest being 6.7 percent recorded in 2002. The strong economic performance was due mainly to the improvement in the primary sector mainly on account of increased production of zinc, textiles, and diamonds.

Although the economy recorded an average of 4.4 percent growth rate for the past five years, it is important to point out that this growth is still insufficient to make a significant impact on poverty and the level of unemployment, which now stands above 30 percent. To reduce unemployment, concerted efforts have to be geared towards addressing the key constraints to economic growth particularly the skills development, export strategies and other related matters. As you may be aware, these and other related issues were discussed recently at the Cabinet Retreat in Swakopmund.

The exchange rate between the NAD and the US$ fluctuated between 6.01 and 6.78 over the last 8 months. On the inflation front, Namibia's annual inflation rate rose slightly to 2.2 percent in August 2005 from 1.7 per cent in July and a record low of 1.3 in June. Despite the recent rise in the level of inflation, it is still relatively low and is well contained. Oil prices remain a threat to the country's inflationary outlook and may create further inflationary pressure in the medium term and thus may affect the economic growth in future.

Since 2000, the Bank rate has been on a downward trend and currently stands at 7 percent. The Bank rate's direction is determined primarily by inflation expectations. Obviously, other variables such as the growth rate and the country's external reserves are also considered.

Looking forward, the economic growth for 2005 is forecasted at about 3.2 percent, which is lower than the growth rate of 6 recorded last year. The deceleration in growth is mainly attributed to the slowdown in both diamond and uranium production as well as contraction of the fishing sector of about -8 percent. The severe contraction of the fishing sector is mainly explained by the high oil prices and the strong local currency. Other sectors such as manufacturing and construction are projected to contribute positively to growth over the next two years. The actual growth rates may exceed the projections if the inflation rate and interest

rates continue to be at a low level, while commodity prices continue to improve and favourable climatic conditions for agriculture and fishing.

Coming back to tonight's topic, let me begin by saying that as you may be well aware, over the recent past, there has been a marked increase in the number of corporate scandals the world over, involving both private and state-owned financial institutions, which have attracted the attention of the media, the public and regulators. Most pronounced include Enron and Worldcom sagas in the USA, and Parmalat in Italy. The Parmalat affair alone is certainly one of the biggest corporate fraud in recent history, totalling over US$ 17 billion. Over 135 000 people lost their money when this company, a flagship of entrepreneurial success in Italy, collapsed. Here at home, we have had our fair share of corporate scandals, where significant amount of public money got lost through improper and probably fraudulent investments.

The main causes of these scandals and improper handling of investments appear to be threefold, namely misunderstanding of the market and its risks; lack of investment management know-how; and outright fraud. In the case of Namibia. there also appears to be indifference to internal controls; a possible erosion of ethics; inability of internal systems to catch up with new ways of committing offences; and lack of due diligence from investors as well as poor understanding of investment mandate.

The effects of such losses arising from financial mismanagement do not only have repercussions for the financial sector in regard to investors' trust and confidence in financial institutions, but if unabated could affect the country's economic performance in the future. These activities also raise questions ranging from the role of regulators to the vigilance by auditors and investors. In the Namibian context, the recent events where money invested got lost has generated widespread debate over the role of the Bank of Namibia and Namfisa – the two regulators of financial institutions in Namibia.

The fundamental question raised by the public touches on the role of these two institutions in investment management. To put things in proper perspective, let me start with explaining the general roles of these two institutions. At the risk of stating the obvious, the Bank of Namibia

regulates and supervises to promote a sound and stable banking system. On the other hand, Namfisa regulates and oversees the operations of the non-banking financial institutions and the services they provide. The role of a regulator is to ensure that only “fit and proper” institutions are licensed to render financial services. They do this to protect the integrity of the financial system and the economy.

As supervisors of financial institutions, our primary responsibility is to guard against systemic failures through promoting stability in the financial sector by encouraging financial institutions to manage their risks appropriately. In this respect we carry out our responsibility by issuing prudential regulations. In developing regulations and practices that help to promote financial stability and prevent financial crises, we as supervisors, are also fully aware of the inherent self-interest that financial institutions have to retain the public’s confidence by maintaining safe and sound operations. No single institution will seek to fail by willingly engaging in practices that would cause the market to doubt its long-term viability. It is therefore to be expected that the primary responsibility rests with the board of directors and senior management collectively in ensuring the safety and soundness of their institutions. In this respect, competent staff and management that are supported by a robust system of risk management processes and controls make up the first line of defence against financial instability or fraud within any institution and the economy at large.

The second function is to resolve problems when they occur so that the financial system remains sound and intact. Recent systemic crises such as the 1997 Asian crises, have taught us that when disaster looms, prompt and decisive supervisory action is imperative to containing the damage that troubled financial institutions can pose on the economy. It is during those times that supervisors are called upon to restore confidence quickly so that consumers and businesses do not loose their hard earned savings and access to credit – the lifeline of the economy.

It will be an omission if I do not add that no matter how good the regulations are, they cannot themselves detect or prevent fraud. Indeed many companies that went under were subject to good regulations including internal procedures. However, the management of those institutions

chose to ignore those regulations anyway. In my view, the effective tool against mismanagement of investments lies in robust internal controls, ethics, due diligence, and entrusting the management of funds in the hands of those that have skills and knowledge to accomplish the aims of the investment mandate given.

We as regulators cannot be expected to assume investment decisions, either to approve or dictate in which companies or financial instruments investors should put their money. That is an investment decision that is best left to the asset managers, trustees of funds, and investors themselves. By implication, this therefore calls for investors themselves to be cautious and exercise a high degree of prudence when investing their money. Investors need to satisfy themselves that they are investing their money in reputable institutions and not in the so-called "fly-by-night" entities. Selecting a fund manager is an art rather than a science. In general, it involves setting of criteria on which to base a selection of a fund manager. Amongst the criteria to consider are that fund managers must:

(a) be able to produce adequate records attesting to the quality and stability of their organizations;

b) provide credible references;

c) have a compliance management system in place that complies with regulatory and internal control procedures.

For funds that are invested in securities, it is important that such funds are placed with a third party/independent Custodian that organizes the physical custody of the investments. The Custodian will be expected to produce a monthly report or at any other appropriate frequency the proof of securities that the company is holding with the Fund Managers. In fact, in the world of advanced technology the Custodian will give an investor online access to the portfolio to enable the client to monitor the movements of securities. To sum up, investigate before investing and do not lose track of your money.

Because of the recent improper handling of investment funds, we have heard some suggestions that we must tighten exchange controls on the presumption that potential fraudsters will not be able to transfer the funds outside the country. Proponents of this

suggestion argue that because the exchange control arrangement within the context of the Common Monetary Area (CMA) allows free flow of capital among member states, this in turn facilitates the transfer of ill-gotten funds across the border. Clearly, this is an incorrect argument that should be dismissed because it places the emphasis on the wrong issue. The purpose of exchange control was never meant to prevent fraud. Exchange control is used as a tool to achieve various objectives such as monitoring inflows and outflows of foreign currency and for the purpose of preserving a country's foreign exchange reserves and safeguarding its balance of payments, amongst others. All individuals are allowed to buy or sell foreign exchange as long as they have supporting documents.

Tightening of exchange controls may, however, be appropriate for the protection of foreign exchange reserves or when it results in local investments - investments that could contribute to sustainable economic development and growth. We should also be mindful that the current trends are to gradually relax exchange controls. In fact, some countries in SADC have already abolished exchange controls. Further, given the globalization and regionalization of financial markets, further strengthening of exchange controls runs counter to the objectives of regional integration. Therefore, the existing exchange controls measures in place can only be regarded as an interim policy measure.

Strengthening exchange controls will not in itself result in good investment management of your funds. Therefore, the solution should be found in good corporate governance. For lack of better words, corporate governance can be defined as a set of best practices that provides for the effective management of an organization in terms of risk management, ensuring compliance, and safeguarding the interests of shareholders and investors. Tricker (1984) summarized the concept of corporate governance as follows: "If management is about running the business, governance is about seeing that it is run properly".

There is no single model for good corporate governance. However, works carried out especially by the OECD, the King II Report, and the Basel Committee on Bank Supervision, amongst others, have identified some common elements that underpin good corporate governance. These include:

- Establishment within an organization of frameworks for transparency, disclosure, accountability and risk management controls.
- Having well qualified and independent board members with a clear understanding of their responsibilities; and
- Clear lines of responsibilities and accountabilities within an organization;

As supervisors, we have an important role to play in promoting strong and effective corporate governance through regular reviews and evaluation of the institutions that we supervise. Corporate governance requires financial institutions to implement organizational structures with appropriate checks and balances underpinned by emphasis on accountability and transparency. It is also required of us, supervisors, that we satisfy ourselves that directors and senior management have sufficient experiences, integrity, and relevant skills and are able to exercise independent judgment about the affairs of their institutions. Internal controls cannot be overemphasized as a core component of corporate governance. In this regard, institutions are expected to have strong, effective and adequate internal controls designed to detect and mitigate risks.

A recent study by PriceWaterhouse entitled “Governance: From Compliance to Strategic Advantage, April 2004” suggested that many financial institutions, while having embraced the principles of corporate governance, they equate effective governance with meeting the demands of the regulators. In other words, they tend to look at governance as just another compliance exercise. Clearly, any institution that regards corporate governance as a mere compliance exercise is missing the point. Effective corporate governance is not only good for the financial system as a whole but individual institutions can also reap specific benefits as a reputation for integrity is no doubt a source of competitive advantage. Hence, it is of importance that corporate governance should be embraced and be regarded as an integral part of overall corporate strategy.

With specific reference to the banking sector, we have taken deliberate actions to address the issues of corporate governance, fraud and other economic crimes. For the purpose of protecting the interests of the public (depositors), the Bank has developed a number of minimum standards and prudential requirements to be complied with by banking institutions. These prudential requirements are designed to limit risk taking to levels that are manageable and that do not place the individual banking institution and the banking system at risk. To this effect, a number of determinations, circulars and directives have been issued. Through regular on-site examinations, off-site surveillance and analysis, the Bank monitors the compliance with these requirements.

To prevent fraud and other economic crimes, banks are required to bolster their surveillance systems and institute adequate internal controls in combating these undesirable activities and report all suspicious activities to the Bank of Namibia. At the minimum, the directive on the appointment of directors, clearly outline a coherent set of rules relating to the appointment, duties and responsibilities of directors and principal officers of a bank to ensure that banks are run by professional management. All these measures will certainly protect both the interests of the public and the stability of the banking system.

Beyond corporate governance and the supervisory regime, the strict enforcement of the provisions of the Companies Act will go a long way in ensuring the safety of investments. We welcome work being carried out by Namfisa on the regulatory framework to strengthen entry requirements and govern the conduct of investment managers. Such a framework will root out malpractices and ensure that those entrusted with the management of funds will do so effectively and efficiently in the interests of the investors and the economy at large. Further, the introduction and enactment of the Financial Intelligence Centre Bill will also contribute to the combating of economic and financial crime in general – hence the speedy enactment of the bill is of essence. Over and above all, we need to broaden awareness of the importance of corporate governance and ensuring that those that are involved in the economic crime face the rule of the law.

Ladies and Gentlemen,

I should add that not every investment that goes bad is because of fraud or skills deficiency. Good investments can also go bad, for example if the market takes a downturn i.e. market risk or when the macroeconomic environment becomes unstable. This is where investment diversification becomes an important strategy for spreading investment risks among different sectors, industries, and securities, while still seeking reasonable returns on your overall investments. Simply stated, do not put all your eggs in one basket as you can expose yourself to significant risks. Therefore, diversifying your portfolio could provide protection to the value of your overall investments in the event of a single investment instrument or the market takes a serious downturn.

Let me conclude by saying that corporate financial mismanagement is increasing. Some analysts suggest that the current publicized irregularities represent only a tip of the iceberg. In my view, the solution is to encourage investors' vigilance, build investment skills, and enforce good and effective corporate governance within our institutions. Such governance is critical to building trust by improving transparency and increasing accountability and confidence in the integrity of institutions and the economy at large. Investors themselves also have a role to play in ensuring that they place their investments with reputable institutions.

I thank you for your attention.