ETHICAL AND CORPORATE GOVERNANCE CHALLENGES THAT ROCKED THE ZIMBABWEAN FINANCIAL SECTOR BETWEEN 2003- 2008

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Abstract

The purpose of this paper was to discuss the ethical and corporate governance challenges that rocked the Zimbabwean financial sector between 2003-2008. The paper has also evaluated the measures that were taken by the Reserve Bank of Zimbabwe (RBZ) to try and address the challenges. It also explored whether the measures were sufficient in nature and adequate in degree. The research adopted the case study design by citing cases of financial institutions which collapsed or faced near closure due to the numerous corporate lapses experienced in the sector. Data collection was through desk research and analysis was qualitative judgmental sampling and this was used to select all the cases cited in this paper. Findings clearly indicated that in all cases where ethical and corporate governance challenges were highly reflected, either the chief executive officer or chairman wielded disproportionate power in the board. This

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unfettered power rose from major shareholding which overshadowed the significance of other directors in the institutions. It came out clear that after liberalisation of the sector in the 1990s, an environment was created in which the Zimbabwean financial services industry could thrive, and where excessive risk taking and an adventurous business culture was embraced. Not only was this embraced by government, and industry, Zimbabwean society as a whole also participated. The measures taken by the central bank were a welcome development despite them being sort of voluntary. The way (forceful in nature) through which the central bank engaged in reigning in offenders was necessary at the time.

Keywords: Ethical challenges, Corporate governance challenges, Insider lending, Board composition and interdependence.

Introduction

The economic liberalization of the early 1990s resulted in a phenomenal growth of the financial services sector in Zimbabwe. This was a welcome development which reflected the positive side of the policy makers in terms of empowering the previously marginalised groups of the economy. This period saw many black indigenous owned banks coming onto the financial markets and this reflected a perception of economic growth for an emerging economy. Hinged on empowerment, it was strongly felt that the new home grown institutions were going to underpin the state's advancement and promoting economic growth. Ironically, despite all these expectations, the financial institutions played a big role in the meltdown of the same economy which in the first instance, they were expected to boost. This might be achieved not only if there were secured external lines of credit being available to the country but also after the quagmire that led to the economic decline was addressed. Above all other reasons that might be cited in the economic and political circles, unsound ethical practices and poor corporate governance systems in the financial sector caused the economic meltdown that characterized the years 2003 and 2004.

The Composition of the Financial Services Sector

At the time this paper was written, the financial services sector in Zimbabwe was comprised of banking institutions, micro finance institutions, fund managers, insurance both short and long

term, pension companies, capital markets and real estates. As noted by the RBZ monetary policy statement(December 18, 2003) on the close link of asset management firms and banks, as well as their fluid nature of operations, their potential use as channels for money laundering activities, parallel market dealings, fuelling of speculative investments, it was the authors' assertion that all the institutions making up the financial services sector in Zimbabwe had a potential for any such of the unethical behavior to occur. The coming in of the current RBZ gorvenor in late 2003 ushered in a new era on the financial services sector as well as bringing to light and much focus of public attention on issues of good business ethics and corporate governance matters. Activities in the sector had been characterised by speculative behavior with banking institutions diverting from their core business of financial intermediation and taking up positions in real estate, equities on the stock exchange, and purchasing of foreign currency on the parallel markets. Speculation by finance institutions was also rife in commodities such as fuel, furniture, equipment and building materials among other non-core business activities.

Brief Review of Related Work

It has been argued that a broader view of corporate governance be adopted in the case of financial institutions because of the peculiar contractual form they possess. As alluded to by Muranda (2006), the argument on this view is that corporate governance mechanisms for financial institutions and more so banks should encapsulate depositors as well as shareholders. As noted by various authors, information asymmetry in financial institutions creates an incentive to invest in risky assets in contradiction to promises made to investors and depositors. As pointed out by Sigurjonsson(2009), whenever deregulation of markets is done by governments, there is lack of critical insights into core processes because of the largely laissez-faire attitude of the government, lack of transparency, and entangled ownership issues within the industry which tend to prevent sufficient public debate to prompt reasonable criticism of both government and industry as happened when the sector was rapidly growing in an unstoppable manner. The phenomenal growth resembled a strong entrepreneurial culture which normally comes along a much more liberalized market. The need for liberalisation is usually an attempt to increase economic efficiency. However, when this happens it resonates with agency theory, public choice theory and organization theory as pointed out by (Vickers and Yarrow 1998, 1991; Martin and

Parkers, 1997;Boycko and Vishy, 1996; Bishop and Thompson, 1992 Villalonga,2000). When liberalization is achieved it normally brings with it entrepreneurship, but entrepreneurship involve risk- taking, which appears to be a factor largely neglected by regulators including governments.

The “entrepreneurial culture ideology’’ indeed seemed to have driven the vast growth of the financial sector in Zimbabwe and unfortunately seemed to have been taken too far resulting in corporate governance and unethical business practices that rocked the Zimbabwean financial sector. The new entrants ideology raised questions related to classic agency problems. As noted by Sigurjonsson (2009), a cross ownership of these institutions revealed lack of transparency which then made corporate governance at the firm level becoming a cause for concern. The root of this could be traced to the time soon after liberalization as more new indigenous players came in the fold and rapid growth was experienced. In a small but, fast growing economy, it was found that ownership was more entwined than in a larger economy.

Deregulation as pointed out by Thomsen (2009), also made it possible for banks to diversify into related activities like insurance services, mortgages, and to organize a substantial share of their activities in off balance sheet operations. According to Sigurjonsson (2009), shareholders would have to rely on corporate governance mechanism to protect their interests. Another governance mechanism is reputational risk. It should have motivated executives to perform well for fear of reputational loss but executives of banks during this period were treated like celebrities. Agency problems cannot be eliminated all together (Tirole , 2006). Nonetheless, the financial sector crisis of the period under review shows how fragile governance issues can become I not properly managed.

Methodology

This paper adopted a cross-sectional case study approach where peculiar cases of rampant ethical and corporate governance challenges were so rife during the period under review. An in-depth analysis of abridged case studies of the financial institutions could have been more ideal, but because of the limited time only an overview of peculiar cases was done. The study thus did not make an in-depth study on particular cases. Data was collected through a desk research and

there was no verification of facts by former employees or directors of the institutions evaluated. Secondary data was mainly obtained from investigations and audit reports done on some of the financial institutions by audit firms, such as KPMG and the RBZ reports in the institutions. Cases were taken from those institutions which experienced financial distress during this period which was linked heavily to corporate governance challenges. Judgmental sampling was used in selecting the cases since many institutions might have also experienced the same challenges.

Ethical Challenges

Whereas it is essential that a director grasp the seriousness of his fiduciary obligation and act accordingly, most directors in the financial sector had become unethical opportunists and hence most of them became dishonest scoundrels. After the deregulation of the sector in 1991, it meant competition was also made rife and most of the new entrepreneurial entrants brought with them innovative new products regardless of how they unethically administered their products and services in quest of posting growth as was reflected in many of the sector's financial results year in year out, after which was a result of numerous unethical behaviors. The unorthodox means of making super profits by the financial sector also resulted in the decline of the sector. Ironically, the emergency of the unscruplous behavior was not only a source of super profits for the institutions but also turned out to be the source of the collapse of most newly established banks.

Legal Issues

Most banks perpetrated fraudulent activities, through the intentional breach of such relevant legislation as the Banking Act (24:20), Banking Regulations (Statutory Instrument 205 of 2000), the Exchange Control Act (22:05), Bank Use Promotion and Suppression of Money Laundering Act (24:24). A former senior executive of Barbican Holdings (Proprietary) voluntarily gave a confidential report on how Barbican Holdings Limited through Barbican Bank (BB)did some fraudulent activities which were all in total breach of the above legal instruments, (RBZ Investigations of Barbican Bank Report, January, 2004). This was also confirmed by an external audit report done by Kudenga and Company Chartered Accountants in their confidential report of January 5, 2004. An investigation which was also done by audit firm KPMG on Trust Bank

(TB) revealed that the company directors approved loans to finance their own offshore investments. In making repayments for the loans they would again violate exchange control regulations SI.109/1996. Section 13 of the regulations prohibits, without authority, the transfer of shares registered in Zimbabwe between persons who are not both Zimbabwe residents and prohibits the issue of shares in a Zimbabwean company to a foreign resident. At one stage TB gave AI Shams 42 296 673 Ariston shares when they had lent Barato USD$1, 933 000-00. Barato was an offshore company to which TB's directors including the Chief Executive Officer (CEO) were again directors and shareholders. The money was siphoned through credit approval formalities within the bank but with a different purpose altogether, (KPMG Investigation on TB, May 4, 2006).

The directors of some of the financial companies would deliberately make false statements concerning the affairs of their companies thereby violating section 343 of the Company Act (24:03) which made it an offence for a director to make false statements. In TB's case, (KPMG Report, 2006) directors misrepresented facts that USD$3 000 000-00 was advanced to and for the benefit of the directors themselves. The directors would then make false entries in the company's books thereby contravening section 345 of the Company Act (24:03). The directors also acted in violation of section 3 of the Prevention of Corruption Act (9:16) which made it an offence for any agent to present any document to his principal with an intent to deceive. This was most common with most of the directors of banks such as TB, BB, Royal Bank (RB) and Time Bank to mention the most affected ones. In these banks directors advanced themselves with non performing unsecured loans.

Corporate Governance Challenges

The corporate scandals and failures witnessed in the past in the financial sector reflected serious flaws and lapses in corporate governance standards. Amongst the lapses were; inadequate board oversight on the operations of the firms which resulted in poor controls and weak risk management frameworks, poor asset quality typified by insider and non-performing loans that became very difficult to monitor. There was also over-concentration of lending to a few associated groups of companies. It had also turned out that most of the financial institutions had

formed other subsidiaries related to the parent company or owned by the directors themselves supposing rapid growth of the businesses. However, as noted by Sigurjonsson, (2009) rapid growth and vast cross-border expansion could not occur without risk. Diversification of risk should have become a significant concern. The institutions needed to vary their revenue streams. However, some firms like BB took advantage of a low interest rate regime and borrowed money from the RBZ which it used to finance operations outside the bank itself but other subsidiaries in South Africa and Botswana as the bank was enhanced to embark on a fast growth strategy. During the period when most of these challenges were experienced, asset growth of the firms was very strong, especially in equity and real estate. This was precipitated by the most prevalent owner-manager arrangement which was in most of the institutions. Through an entrepreneurial strategy, a lot of malpractices were committed by the executives. The challenges were mainly manifesed in most of the firms as follows; absence of relevant board committees contrary to sound corporate governance practices. In many instances the executive board members would be the directors of the subsidiaries; illicit payments to parent firms and lack of internal control procedures. These corporate governance challenges were explicitly manifested as follows:

a) Board Composition and Independence

Due to the cross ownership arrangement within the financial institutions themselves, corporate governance issues remained convoluted and opaque. There was rampant inadequate board oversight on the operations of the firms which resulted in poor controls. There were in most cases no separate and independent boards for subsidiaries and the holding companies as reflected in the BB, TB, RB, and Time Bank. Board composition also reflected much on the appointment of management teams, making the majority of managers having closer links with the directors and owners of the firms. This compromised heavily on professionalism. It seemed no "fit and proper" test was ever done. Board members consisted mostly of self-made entrepreneurs without any banking or financial experience. A good example was in the Metropolitan Bank (MP). They were in most instances, the firm's larger shareholders and big debtors. This was unfortunate given the specific role of corporate governance within banks in particular.

Corporate watchdogs argue that the more homogenous a corporate board is, the more successful it will be in discharging its responsibilities. It thus follows that for this effectiveness to be achieved then diversity in terms of professional mix, gender, race, experience and skills is vital. Time Bank one of the banks with a very short and controversial history in Zimbabwe, had a board of only five (5) directors to which case the majority were executive directors. The composition of this board also violated the banking act which required the majority members to be non executive directors. Another questionable arrangement in the Time Bank board was that the CEO's secretary also held about 25% in Time Bank Investment Company which had 92,5% shareholding in Time Bank. In complying with the RBZ guidelines Time Bank then changed its shareholding structure in manner that kept the CEO at the helm in his executive position now with 9%. The bank also had no credit and audit committees. Firms with lower proportion of outside directors and with the CEO acting the chair of the board of directors were more likely to experience financial failure, (Schener, 2003). For a board, the key indicator that financial distress exists in the business is its inability to meet contractual debt obligations, (Muranda, 2006). Muranda (2006) further stresses that, boards controlled by inside directors and managers acknowledge presence of problems when they cannot hide them any longer or resolve them. A study of companies in crisis situations has consistently revealed an apparent link between corporate decline and board inadequacy and ineffectiveness, (Coulson-Thomas, 1995). Board chairmanship lacking power and leadership leads to inadequate oversight over the board and management. This is a strong source of corporate governance failure, (Muranda, 2006).

b) Inadequacies of Internal Controls

Internal control systems in simple terms are in-house procedures, processes or methods that a firm uses to regulate or manage the conduct of its business in order to safeguard its assets and meet the business objectives and goals. According to a special report published by the Conference Board, Inc, USA in 2003, internal control is a process designed to provide reasonable assurance that an organization is achieving its objectives by helping it to:-

- Protect its assets and shareholders' investments,
- Ensure it is not overly exposed to risks,
- Improve the reliability of internal and external reporting,
- Promote compliance with applicable laws and regulations,

- Improve the effectiveness and efficiency of operations.

The board of directors as part of its fiduciary duty to shareholders is ultimately responsible for ensuring that the company has adequate internal control systems in order to safeguard shareholders and stakeholder investments as well as company assets. The owner/manager type of management systems which was prevalent in this sector could not allow for an enablement environment for this to be achieved adequately. This was most noted in RB, Time Bank, TB, BB, Intermarket, and ENG Capital. Lack of controls also resulted in high systematic risk. When ENG collapsed, its sister company Century Discount House got heavily exposed and was liquidated. First Mutual Assurance was also heavily exposed to ENG and had to be suspended from trading on the stock exchange.

Asset management firms failed to provide the RBZ with basic information pertaining to their operations for registration purposes vindicating the RBZ'S suspicions. By March 2004 only four (4) out of fifty five (55) asset management firms which had submitted applications for registration with the RBZ as per the new requirement set in the December 18, RBZ Monetary Policy Statement had managed to provide all the relevant and required information. They even failed to raise Z$5million registration fees but still deemed themselves suitable to hold and manage large portfolios of investor funds.

c) Insider Lending

The other corporate governance challenge which the financial sector faced was insider lending. There was heavy insider lending which was not reviewed with the supposedly credit and loan review committees. The loans were given between directors themselves or to offshore companies or subsidiaries as was mainly manifested in TB and RB. The loans would also not attract interest and would not have any bonds to be used as collateral. They were "bullet loans", where the debtor pays principal at the end of the loan period, which in most cases would be extended as pointed out by, Margunblaoio (2009). Most of executives and board members were personally liable for their debts. A notable case of lending to an insider company was manifested at Time Bank through an imprudent land scheme with Watermount Estates, (RBZ Report on Time Bank, August 2006). The executive chairman of Intermarket Holdings loaned himself Z$90billion of depositors' money and the insider loans were not being serviced. The executive chairman had veto power on almost everything happening in the institution.

d) Non-Separation of Accounting Functions

Most of the banks belonged to holding companies. In such cases, for example TB, BB and Intermarket to mention but a few had other non-banking subsidiaries within their groups to an extent that they would mix non-banking business with banking business. There was no physical separation of the books of accounts of the asset management arms from those of the banks. The assets and liabilities of the banks were being accounted for under the asset management company with reallocations processed through journals. This was very typical with Barbican group.

Board Composition, Function and Independence

The corporate governance guidelines no. 01-2004/BSD and no. 02- 2004/BSD became the guidelines for the financial sector effective 30th September 2004 as part of the integral measures in resolving the crisis. The guidelines attempted to maximize the shareholder value by emphasizing their power in ensuring directors accountability, responsibility, efficiency and effective governance of banking institutions. Some of the previous set ups where the owner would be chairman of the board at the same time being the CEO were adequately addressed. Paragraph 2.2.2 of guideline no. 01-2004/BSD was very welcome in that it was further qualified by section 18(3) of the Banking Act (2420). Sora and Natale (2004) argue that the conjoining of CEO-Chairman roles creates raw power, unchecked power. Muranda (2006) in citing Sora and Natale asserts that such a scenario leaves the governance of the corporation in the hands of one person and there will be great potential that board members are friends of the CEO-Chairman.

Conclusion

The paper examined the corporate governance and ethical challenges faced by Zimbabwe's financial institutions in the recent past. It also put out clearly that after deregulation there seemed to be a strong entrepreneurial culture and growth which however needed to be balanced with the risk exposure and sustainable societal development. Where risk issues and issues of balanced development are largely ignored sustainable banking face challenges. It can also be noted that having good laws but without proper structures of sound corporate governance systems firms

were more likely to experience corporate lapses and bankruptcy. The RBZ guidelines came in at a highly polarized point in the country and this overshadowed the good intent they had and hence were personalized. However, as far as corporate governance awareness in the country was concerned, at least the awareness levels were upped. Despite heavy presence of civic society in the nation at the time when the crisis was exposed as well as the guidelines coming in to harness the already bad situation, they lacked critical insight into core processes. Presumably, a critical non-governmental organization and analyst engagement with good information could have triggered a much more adequate public debate, which would again have put pressure on both government and industry.

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