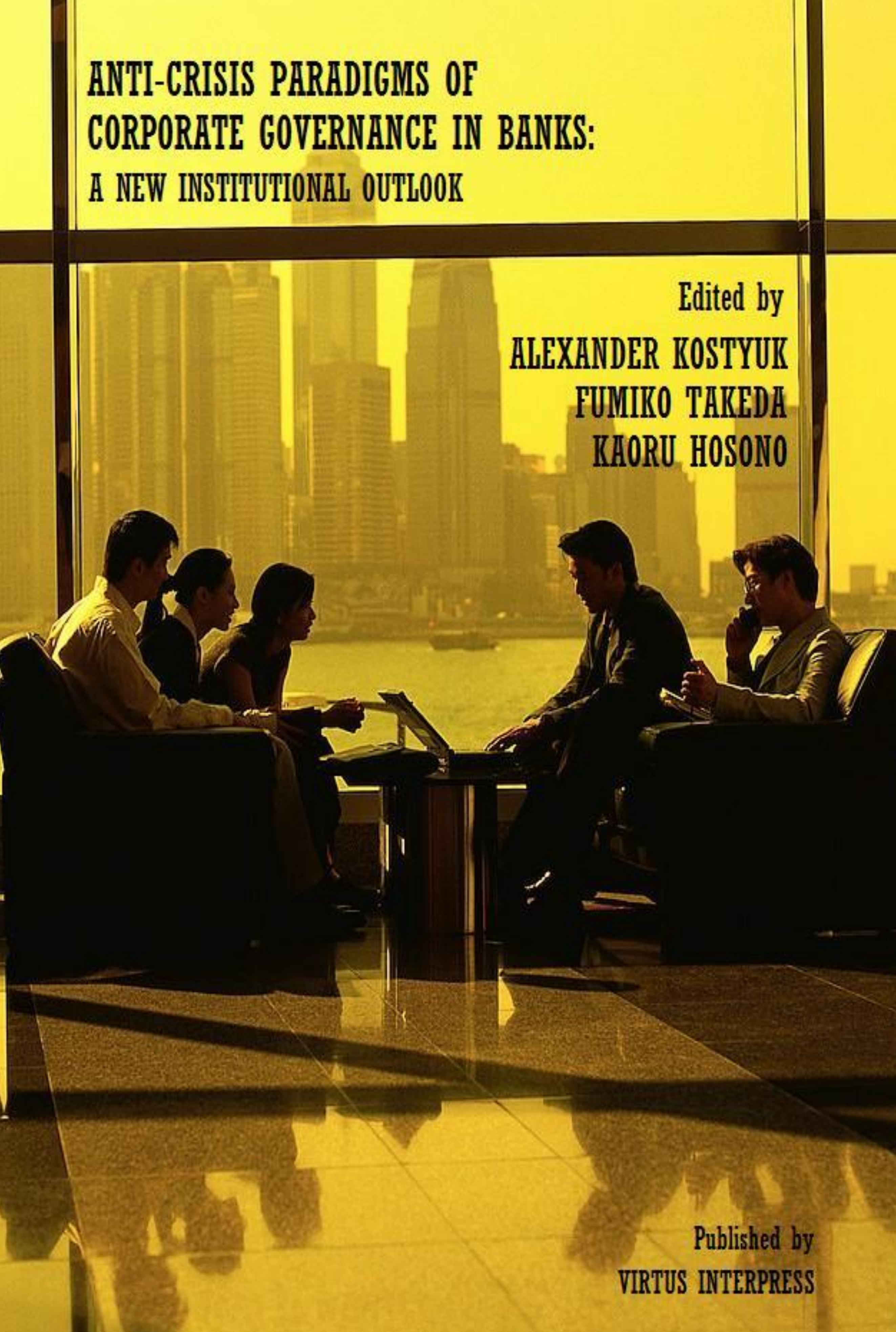
ANTI-CRISIS PARADIGMS OF CORPORATE GOVERNANCE IN BANKS: A NEW INSTITUTIONAL OUTLOOK

Edited by

ALEXANDER KOSTYUK

FUMIKO TAKEDA

KAORU HOSONO



Published by

VIRTUS INTERPRESS

VIRTUS INTERPRESS®

Virtus Interpress
Kirova Str. 146/1, 20
Sumy, 40021
Ukraine
www.virtusinterpress.org

Published in Ukraine by Virtus Interpress

Virtus Interpress
Postal Box 36
40014
Sumy
Ukraine

ISBN 978-966-96872-1-0

ACKNOWLEDGMENTS

We would like to address a lot of thanks to our colleagues from many countries of the world. In writing this book we have been helped by many colleagues and friends.

We are pleased to deliver our warm regards to Paul Chisnall, an Executive Director of British Bankers' Association, an expert taking active participation in banking reform in United Kingdom. His contribution through writing an Introduction delivers value to our book.

As a co-editor of the book I would like to address my personal congratulations to Fumiko Takeda and Kaoru Hosono who are well-known experts in corporate governance in Japan and worldwide. It was honor for me to work in a team of such well-ordered and highly motivated persons who like the process of work as much as possible and try to deliver this attitude to work to other people.

Our contributors are worth of special thanks. We have enjoyed writing the book. The process of writing was like the bee team working when each participant brings the best value to the joint work.

Special thanks are addressed to our colleagues and administration of the Ukrainian Academy of Banking of the National Bank of Ukraine. Optimistic and open-minded attitude of the Chancellor of the Academy, Prof. Yepifanov, and Vice-Chancellor in Research, Prof. Kozmenko to the international research projects like this one was an incentive for us to work hard. Therefore, it has happened not by chance as the book gives a birth to the new international project of the Academy – International Research Center for Banking and Corporate Governance. Many experts contributed to the book coming to the Center as its members.

The most important words of acknowledgment should be addressed to our families who supported us in undertaking this work. Thank you very much!

Alexander Kostyuk, Fumiko Takeda, Kaoru Hosono

INTRODUCTION:
A Practitioner's Outlook

The financial crisis

The crisis engulfing the World's financial markets for the past two years has involved coordinated action on the part of governments, central banks, regulators and the industry itself on a scale rarely seen and as we enter 2010 the signs are that the crisis has been abated.

During this time there has been much debate on the underlying causes of the financial crisis and the broad consensus is that the blend of macroeconomic factors and intellectual assumptions that contributed included:

- Global macro-imbalances which had grown rapidly over the last ten years combined with financial innovation stimulated by the imbalances;

- Rapid credit growth in some countries fuelled by significant wholesale and overseas funding;

- Fault lines in the global regulation and supervision of cross border banks; and

- Failings in the intellectual assumptions on which regulatory approaches have been built concerning market theory and the nature of risk.

It is clearly also the case that many banks over-estimated their capacity to mitigate risk and that - whether in terms of culture, appetite or processes - their boards and risk management fell short of the required standard.

The understanding of the broad nature of the underlying causes of the crisis has guided the regulatory response. Much of this activity has been guided by the Financial Stability Board, reporting to the G20, and in broad terms this regulatory change has comprised three components: to strengthen the resilience of the financial system; to reduce the impact and systemic effect of bank failure; and to improve intergovernmental and cross-agency cooperation.

Reviewing corporate governance

Corporate governance sits at the heart of the regulatory infrastructure in which banks and other businesses operate and given the magnitude of the financial crisis many are asking whether governance arrangements are as robust as they need to be.

While ‘tougher’ regulation may be seen as part of the solution to the crisis, is this necessarily the case for corporate governance? Do codes require major revision? Does the crisis warrant a shift in the balance between statutory requirement and code provision? The question, of course, is whether the model of corporate governance in itself can be said to have been a contributory factor in the crisis, or whether governance failures were more idiosyncratic in nature, relating to individual firms and the way in which they translated code provisions into practice.

Here in the UK, the review conducted by Sir David Walker on behalf of the Prime Minister concluded that there was little in the way of evidence to suggest that corporate governance based on statutory provision would have resulted in companies coping with the crisis any better than they did. The review finds therefore that the UK’s Combined Code on Corporate Governance and its “comply or explain” approach remains an appropriate medium for setting out the rudiments of what constitutes good governance.

In concluding this, the review made a distinction between what it describes as *errors of commission,* often associated with specific events or decisions, which are generally more identifiable for the purposes of legislation, regulation and enforcement, and *errors of omission,* which tend to stem from behavioural processes or deficiencies and which can be more difficult to pin down. The review found that some organisations faired better than others in the crisis and from this made the logical step of determining that it should consider whether those institutions which faired less well in the crisis would have benefited from practices followed by those that faired better.

The review therefore identified a number of factors that may have contributed to the downfall of those institutions that did not survive the crisis and drew up recommendations based on the practices followed by those that proved more resilient. In all, the UK review found little need to make changes in the role and constitution of the board and instead its 38 recommendations clustered around five key themes: board size, composition and qualification; the functioning of the board and evaluation of performance; the role of institutional shareholders; the governance of risk; and remuneration.

Recommendations included placing more rigour around the recruitment of Non-Executive Directors, their support and the identification of a minimum time commitment in respect of major bank boards. The review also questioned whether the right balance between independence and experience had been achieved. A more disciplined approach was recommended in respect of the functioning and evaluation of the board, its committees and its members. Institutional investors were encouraged to become more engaged. Greater emphasis was encouraged on board oversight of risk management, with the establishment of a board risk committee to sit alongside the audit committee and the appointment of a Chief Risk Officer, reporting to the CEO or CFO. The review also embraced the Pittsburgh principles on remuneration in making the case for the deferral of a proportion of performance-related pay and enhanced transparency.

The review gained wide acceptance within the banking industry early in the process and if some had concerns then these tended to be about scope and emphasis. Most agreed with the image provided of what constituted good practice; questions related more to whether specific proposals necessarily applied across the community of banks irrespective of size and whether or not improvements in practice deemed appropriate for large financial institutions were necessarily relevant to smaller or non-listed institutions. All recommendations were broadly accepted.

Concluding remarks

Corporate governance provides the means by which an institution ensures that it is functioning in an intelligent and risk-sensitive manner within the environment in which it operates. Its best practice can rarely be expressed solely by reference to statutory provision and usually needs expression through some form of market-based code. While these differ in their nature, there are many common strands and the types of issue that are topical in one jurisdiction may well be of interest in another. This is particularly true in respect of banking where the business tends to face risk of a similar nature - but with varying relevance and impact.

The UK review has taken place within the context of initiatives conducted internationally by the Basel Committee on Banking Supervision, the European Commission, the Financial Stability Board, the US Securities and Exchange Commission, the OECD and others. Four criteria guided the review: whether proposed changes would add value over time to the benefit of shareholders, other stakeholders and society more generally; whether they would contribute to placing greater emphasis on achieving a longer-term horizon; whether they would build on the "comply or explain" approach; and whether proposed improvements could be said to be both proportionate and capable of practical implementation.

As this volume shows, there are differences in the approach to corporate governance adopted in individual countries and in the statutory provisions that underpin governance arrangements. In each instance, however, statute tends to be fixed – or relatively fixed – whereas governance practices reflected in codes tend to be more responsive to changes in approach and application. The nature of change needed to governance arrangements will vary across countries and will depend upon the extent to which behavioural shortfalls in particular companies can be said to have been a contributory factor in their finding themselves more exposed to financial shocks.

The lesson from the financial crisis is that the fundamentals behind the "comply or explain" approach remain as strong as ever. The question is how best their application should evolve and whether there are changes in approach relevant to the banking industry that merit broader application.

Paul Chisnall

Executive Director

British Bankers' Association

INTRODUCTION:
A Practitioner's Outlook

The financial crisis has revealed among many other issues, the importance of corporate governance in the banking system. Some major governance shortcomings have been revealed, stirring a considerable interest in the subject, both in terms of regulatory initiatives, supervisory action, and even ex post corrective analysis. In almost all states where the crisis has lead to major state intervention in the banking system, enquiries and investigations have looked into the weakness of the internal organisation of the financial institutions including their governance bodies, leading to conclusions that will be dominate the debate for the next decades. Therefore the present book, containing a series of studies covering most of the developed banking systems in the world is particularly well timed and will contribute to the in-depth reflection on the way banks have to be governed and man aged in the future.

Governance in banks is of a particular nature: it embodies not only the interest of the bank and its shareholders as in any other business enterprise, but also determines the way the banks interact in their community, with their clients, be they depositors, investors or companies, as well as with their employees. But most importantly and dramatically illustrated in the financial crisis, it has a direct bearing on the bank's risk profile and hence its potential impact on the overall financial stability. Ultimately and in a broad sense, weak governance has been one of the significant factors that lie at the basis of the crisis and has indirectly impacted financial stability. And when the crisis hits, governance matters will be the first and most visible victim: chairs and CEOs were ousted, shareholders eliminated, compensation blocked or even reclaimed. All this illustrated the core role of governance.

One will therefore not be astonished that regulators in several parts of the world have been looking closely at the banks' governance. This book rightly gives a wide overview of the different governance approaches allowing on the basis of a thorough factual analysis to position governance against the background of the economic structure of the banking sector. This illustrates once more that notwithstanding the many commonalities in the governance systems of the different jurisdictions, that attention has to be paid to the specific social and legal environment in which these banks function. The fundamental divide between banking groups with dispersed or with concentrated ownership, but also the presence of more or less significant state intervention and state holdings will here call for appropriate solutions and at least draw special attention. Solutions that may have proved resilient in one system are not necessarily the best suited ones in another. There is no one size fits all in corporate governance.

Recommendations have been tabled calling for more radical guidance for the banks' governance, and even for formal regulation especially in the field of compensation. And well trodden paths will have to be challenged. Requirements for board members are likely to become more demanding, calling for regulators to investigate more in depth and not on mere formal procedures, the personality, the competence, the character of future directors. The drive for independence may as a consequence be considered less of a priority.

Risk management is likely to be among the highest priorities in the post crisis bank management. The relationship with the bank's board and its specialised risk committee requires specific guarantees to insure not only that the instruments for risk identification and measuring are adequate but also that the board and its committees remain fully informed of the risk profile. The chief risk officer should therefore have an independent status and have direct access to the board's risk committee.

Monitoring the boards is a difficult exercise: some put forward the idea that the regulators should monitor more closely the functioning of the boards. However this monitoring is likely to always remain external, formal, and incapable at looking at the substantive issues in depth. In the UK, where shareholders are most of the time widely dispersed, more reliance is placed on the role of the long-term shareholders and their stewardship of the company. On the European continent, and in many other jurisdictions around the world, the important shareholders often exercise this role. This book contains some useful data that may help the reader to consider which system produces better results, not only in terms of financial returns, but also of stability.

Prof. Eddy Wymeersch

Chairman of the Committee of European Securities Regulators (CESR)

INTRODUCTION:
An Academic Outlook

Students of economics are taught the importance of incentives. In the absence of perfect capital markets, the design of contracts becomes critical as contracts, both explicit and implicit, are the mechanism for aligning incentives faced by economic agents with the desired outcomes. Corporate governance in its most basic form is the set of contracts between the principals in a firm – or its stakeholders – and their agents, including management and employees. After all, the role of corporate governance is to align the interests or management with those of stakeholders.

Banks present a unique challenge in terms of the corporate governance. This is true, if for no other reason, simply because banks in most countries perform a special role in the economy. This is not necessarily because banks are inherently special on their own, but they are often treated as special, where the specialness emanates from some combination of a public purpose a bank takes on as a condition of their charter and special privileges – such as access to the public financial safetynet – endowed upon banks as part of their charter. The specialness is reflected in the government (or public) being an important stakeholder. Access to safetynet and the possibility that the failure of one or more banks could have material negative spillover effects on the real economy increase the importance and complexity of corporate governance for banks. Hence, corporate governance for banks goes beyond the usual set of contracts present for nonfinancial firms to include a high degree of government interference in the operations of banks through formal contracts in the form of regulation and informal contracts embodied in supervisory oversight.

This volume put together by Professors Alexander N. Kostyuk, Fumiko Takeda and Kaoru Hosono adds an important perspective to our understanding the corporate governance in banks. A one size fits all system of corporate governance is unlikely to fit the needs of any nation’s financial system. That is, in presenting the operation of banks and the governance systems in place across a variety of countries –developed, emerging market, transition, etc. – the reader is confronted with the importance of the institutions, laws, legal tradition and the nature of a country’s financial system in the form of corporate control faced by banks. For instance, a different structure for corporate boards of directors is required in countries with well-developed equity markets than in countries with highly bank-centric financial systems. Taking this insight a bit further, this book presents a challenge to international efforts to harmonize bank regulations and the form and degree of supervisory oversight. That is, bank capital regulation and other forms of public sector corporate governance in banks need to be consistent with, and take into consideration, the existing institutions and legal environment of each individual nation.

Dr. James B. Thomson,

Vice-President,

Federal Reserve Bank of Cleveland, USA

LIST OF CONTRIBUTORS

It is a pleasure to declare that the contributors to this book are well-known experts in corporate governance in banks. They represent more than 20 countries of the world. Taking into account that corporate governance in banks is quite new and unique area of research it could be taken for remarkable progress of the academic community. Moreover our contributors represent both academic and corporate worlds. Representatives of British Bankers' Association, Federal Reserve Banks, European Commissions, universities from developed and developing economies composed the perfect team of contributing authors.

The full list of these well-known experts including their affiliations could be found at the end of the book. Besides that the names of authors could be found also in the chapter headers of the book.

CONTENTS