

**Financial Distress:
Corporate Governance & Financial Reporting
Issues**

Edited by
Alexander N. Kostyuk
Olga Afanasyeva
Yuliya Lapina

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PREFACE

The world is recovering from a period of tremendous turmoil and instability in the capital markets, it is more important now than ever that governance system, regulations and accounting standards promote right decisions, policies and transparent financial statements that support sustainability and safe economic development. Weak accounting and not accurate financial reporting led companies to wrong governance decisions that provoked an enormous catastrophe which still echoes for the global economy. One of the major problems in modern business world is that most stockholders are divorced from the running of the business so they may not have the appropriate level of knowledge to assess their management's stewardship of their assets. This agent-principal problem can be solved by proper accounting and reporting practices and further improvement of governance standards. So ensuring the integrity of the essential reporting and monitoring systems will require boards of directors to set and enforce clear lines of responsibility and accountability throughout the organization. The main aim of the book is a search for an effective relationship between management, financial reporting and stability of the economic system in crisis and post-crisis conditions by creating meaningful proposals by representatives of different research schools, regulatory bodies and practitioners.

CHAPTER 1

NON-BANK FINANCIAL COMPANIES VS. BANKS IN THE EUROPEAN UNION: A SERIOUS REGULATORY ASYMMETRY WITH CONSEQUENCES

Grażyna Szustak

Introduction

The on-going financial crisis, hailed as the crisis of the 21st century, and its consequences in particular have resulted in the EU regulators undertaking some emergency initiatives aimed at restoring the security and stability of the heavily tarnished banking sector – a sector that occupies a prominent place in terms of the assets of the Community's financial market, as it accounts for as much as 350% of the EU GDP. Among the regulatory changes currently taking place in the banking sector, a particularly important one is the incipient process of creating a banking union, whose primary aim is to rescue banks, especially those in the euro area by means of macro-financial supervision, the European Financial Stabilisation Mechanism, and common deposit guarantees. Furthermore, prudential norms are being tightened further due to the obligatory requirements imposed on banks by Basel III as, in the view of the regulators, Basel II proved too lenient, and the focus on micro-prudential supervision was incorrect. The time has arrived for definancialisation of the European economy as well as some deleveraging activities in the financial sector, a legitimate objective of the revised Basel framework provisions. However, the question is whether the right direction for the regulators is to focus primarily on the banking sector or not. It seems that it is not. While restrictions were being imposed on banking operations, the market failed to observe the growth of the shadow banking sector, also referred to as the parallel banking system or the shadow area, even if it was growing with the active participation of the banks. It has developed and continues to grow since the shadow area's assets in the EU are rising. At the same time, the sector also generates a high, uncontrolled risk which poses a real threat to the financial stability of the EU's financial sector.

Therefore, this paper aims to identify the roles and motives of banks in the creation and development of EU NBFCs, with a particular focus on regulatory concerns. It also analyses the consequences of the banks' actions, which are now coming to the surface. Bearing in mind the above-described objective, the paper defines the concept of shadow banking, the scale of the relevant phenomenon, the risk generated by shadow banking, and the role of regulators and banks in the expansion of the sector. Finally, it assesses the European Commission's efforts in 2012 concerning future regulation.

In order to achieve this objective, several research methods had to be employed, including scientific observation and induction, so as to generalise the information contained in the paper, and deduction in order to draw conclusions and conduct scientific criticism.

1. Shadow Banking in the EU - Overview of the Problem

The definition of shadow banking was proposed by the European Commission in its Green Paper on Shadow Banking (2012). The Commission understands shadow banking as the system of credit intermediation that involves entities and activities outside the regular banking system¹. Although the definition is not the most precise one, the European Economic and Social Committee is still of opinion that the lack of a generally agreed definition is no obstacle to the regulation of the shadow banking sector. Instead, the Commission identified two pillars on which the shadow banking system is based. They are:

- the entities engaged in the following activities: offering products with deposit-like characteristics, performing maturity or liquidity transformation, undergoing credit risk transfer, and using direct or indirect financial leverage;
- the activities of such entities, including securitisation, security lending and repurchase transactions².

What subjects should be covered by the concept of shadow banking? In principle, all entities other than banks whose activity overlaps with banking activities to any extent. These are: investment funds (e.g. Exchange Traded Funds), hedge funds, private equity funds, including venture capital, financial and credit intermediaries, lending, factoring and lease companies, as well as currency exchange bureaux. [Masiukiewicz, 2011, p. 387]. The list also comprises entities trading in securities, entities providing credit guarantees, insurance and reinsurance companies that issue or guarantee credit products, securitisation companies, Special Investment Vehicles (SIVs), Special Purpose Vehicles (SPVs) and Asset Backed Commercial Paper Programmes. It is worth noting that the above list is not exhaustive. There are many other entities, generally having no specific operational framework or even naming conventions, which constitute a real threat, especially in the face of crisis. Some EU countries go even further by including on their NBFC lists the postal service (France) or co-operative businesses (UK)³. One may also wonder whether this broad circle should not include credit rating agencies, given their functions in the securitisation process.

Consequently, if we consider so broad a list of entities as forming the parallel banking system, as well as the diverse profile of their activities, we

¹ Komisja Europejska. Bruksela, dnia 19.3.2012 r. COM(2012) 102 final (http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_pl.pdf)

² Szygiel J., UE walka z cieniem, „Bank” 2012, Vol. 4, p. 15.

³ http://zif.wzr.pl/pim/2012_4_2_1.pdf (30.05.2013).

can actually derive a broader definition of shadow banking, extending it to all entities other than banks but rendering typical banking services to any extent, both in terms of assets and liabilities, as well as performing intermediary operations (maturity, liquidity and risk transformations; using financial leverage), without being subject to regulation typical of banks, and financial supervision, and thus not ensuring due customer protection in the event of bankruptcy. The latter issue is very important, as numerous institutions from the shadow banking segment start their business activity fraudulently to lure customers using high and guaranteed gains, and then extorting funds from them. As they are not intending to invest the money, they employ creative accounting schemes and present customers with fictitious profits, thus developing typical pyramid schemes. A spectacular example of such activity was the world's largest Ponzi scheme operated by Bernard Madoff, which collapsed at the height of the crisis, in 2008. In that case, losses were suffered by major banks, universities, politicians, etc. More often than not, however, the real victims are consumers who lack adequate knowledge of investment rules, the risks related to investing on the financial market and legal regulations, so are the easiest to beguile. If the institution to which they have entrusted their money in good faith goes bankrupt, it is frequently tantamount to consumer bankruptcy or serious financial losses at best. Dire consequences await not only the investors, but also the customers who use the services of lending companies, since the interest rates in the loan offer are incomparably higher than those of the banks, in some extreme cases reaching 100-120% p.a. Commissions tend to be huge as well. Finally, another dangerous market player is the payment agency, which act as an intermediary in the repayment of debtors' liabilities (most of which are large) to their creditors. Unfortunately, numerous practical examples are known of entities that fail to transfer customer payments to their final addressees. Apart from the need to reduce the risk of NBFCs and regulate their cooperation with the banking sector, customer protection is one of the main reasons that necessitate quick but reasonable regulation of shadow banking entities' operations. Sadly enough, until now it has remained rather on the sidelines of EU financial regulation and supervision. Meanwhile, in Europe, this market is very creative and growing, although the rate of its growth varies across the EU. At the forefront we find the UK, France and Germany [Szpringer, 2009, p. 183]. However, the Netherlands are not far behind. The Financial Stability Board (FSB) estimates the global shadow banking sector assets at USD 67 trillion, a figure equivalent to the annual global GDP, which according to the International Monetary Fund amounted to USD 69.9 trillion in 2011⁴. According to the Bank for International Settlements (BIS), of this figure, in 2011 the euro's share was as much as EUR 15.3 trillion, representing 25%

⁴ <http://www.bankier.pl/wiadomosc/67-bilionow-dolarow-w-finansowej-broni-masowej-zaglady-2683205.html> (30.05.2013).

of the total assets of its entire banking sector (estimated at EUR 38 trillion)⁵.

Risk is an inherent part of financial sector activities. The statement is fully applicable to shadow banking entities, which form, as we can see, a substantial part of both the global and the EU financial market. Excessive risk can lead to the emergence of systemic risk, and consequently to financial crisis, or, in other words, financial instability with all its consequences for the economy and its entities [Davis, 2003, p. 2]. The United States learned only too well about this, since a key factor in the outbreak of the American crisis in 2007 were para-banking activities in the shadow area carried out in cooperation not only with the banking sector, but also the real estate market and insurers. The business of shadow banking entities, diversified, and almost identical to that of the banking sector as it is, as well as its operational scale, expose such businesses to the same risk as banks, namely: credit risk, market risk, operational risk, liquidity risk and other typical risks. The following are considered the most dangerous of shadow banking activities, generating the highest risk: extending maturity dates (combining loans with credit default swaps (CDS)), lowering the degree of liquidity, only partially effective transfer of risk, the use of high and often hidden financial leverage (here it seems appropriate to introduce regulation setting the maximum acceptable leverage ratio)⁶. The risk to which shadow banking entities expose themselves, and errors in risk management, do have an impact on the banking system as well, thus also threatening a stability already battered by the current stability crisis. Both categories, i.e. the banking system and shadow banking interpenetrate each other, and they are linked both directly and indirectly. Typical examples of risk transfer channels to banks include banking loans taken out by NBFCs or contingent liabilities.

2. Overregulation of Banks. Effect of Regulatory Arbitrage. Green Paper on Shadow Banking

Indeed, it was the banks themselves that contributed to the development of the financial market sector that is discussed here. As a result, they are now forced to compete with that sector, and bear the consequences of non-existent risk management. The reasons for this attitude on the banks' side seem obvious. Banks are constrained by financial supervision and legal rigours, especially supervisory prudential standards (the most important EU regulations in the field of standards, supervision and risk are listed in Table 1). However, they have an appetite for risk and wish to increase their rates of return, without the need for costly recapitalisation to compensate for the bank risk level.

⁵ <http://www.obserwatorfinansowy.pl/forma/analizy/banki-wyhodowaly-monstrum-ktore-je-teraz-podgryza/> (30.05.2013).

⁶ <http://www.obserwatorfinansowy.pl/forma/analizy/shadow-banking-czyli-pieniadze-w-strefie-ryzyka/> (27.05.2013).

Meanwhile, the process has begun under Basel III of deleveraging banking operations, which allows for the strengthening of banks with equity, good quality, changes in liquidity requirements for banks, a gradual move away from risky derivatives to increase lending to businesses, and economic development. It also targets the bank staff remuneration system and provides sanctions for irregularities.⁷ There is no doubt that the activities of banks, which play a special role in the economy as institutions of public trust, must be regulated. However, the decision to tighten the rules of banking operations must be preceded by a regulatory impact analysis, as the new controls cannot be too radical. This view is supported, among others, by the European Parliament's Economic and Monetary Affairs Committee (ECON). Over-regulation is therefore as dangerous as under-regulation. Paradoxically, it is the regulated banking sector and its morbid desire for higher profits that became one of the pivotal triggers for the crisis (American subprime loans, investments in junk bonds). In addition, regulation is not enough, as it is also necessary to ensure that the sector could function on the market that is predictable and stable in both legal and economic terms. It is also known that focusing on micro-prudential supervision coupled with underestimation of macro-prudential supervision has proved a failure. Now, crisis-time supervisory changes are meant to save the day, most importantly including the banking union with the European Central Bank (ECB) as a macro-level supervisor for banks in the euro area.

While acting within the constraints imposed by Basel II, and its current amendment known as Basel III, banks are, unfortunately, deliberately moving part of their business to the freely regulated, and sometimes completely unregulated, shadow area. In fact, banks are the main entities to set up NBFCs. The FSA has established that the share of British banks in shadow banking assets in the UK is as high as 92%, whereas the assets of Italian banks in the Italian shadow banking market account for 98%. So it is obvious that the banks do whatever they can to bypass the prudential standards that bind them. For example, if an investment bank sets up a Structured Investment Vehicle (SIV) – a conduit which is very popular among shadow area entities – and starts transferring its balance sheet assets there, then its operating freedom and financial leverage will increase, while the solvency will remain at the level required by the supervisor. On the other hand, the SIV will use the bank assets thus purchased to issue debt securities, whose rating will be high, because the company is a bank-owned vehicle. Low risk means low interest rates. And the return on investments (financed with the proceeds from the issue and sale of commercial papers) on derivative instruments are huge during an economic boom. In such a situation, it is hardly surprising to see similar measures undertaken by commercially-minded banks.

⁷ Minkina P., *Lekarstwo na kolejny kryzys. „Bank” 2013, Vol. 5, p.11.*

It seems that the best solution will be to deprive them of such opportunities by means of tightening up EU law. Standards creation is insufficient in itself, if the regulators fail to regulate the activities of banks in a comprehensive way (previous Basel Accords were strict about the regulation of the banks' balance sheets, while omitting their off-balance sheet activities)⁸ and do not prevent the circumvention of such standards. Therefore, banks are not, as it has been demonstrated above, the sole culprits of the uncontrolled growth of the shadow banking market. Previous actions of the regulators are incommensurate with the development of NBFCs. Now it is time to change the current state of affairs. It is all about implementing restrictions on NBFC activities, which are similar to those imposed on banks, and thus working towards improved security and reduced leveraging. An effective system for the control and monitoring of banks' links with the shadow area should also be implemented, with a simultaneous assessment of the effects of such cooperation (the actual level of financial and non-financial risk thus generated, detection of systemic risk accumulation, and a strong role for macro-prudential supervision). It is not an easy task. Firstly, the NBFC market must be thoroughly diagnosed: the existing laws governing the legal framework for NBFC operation must be analysed, and possible legal solutions thought through. It is because we would like to avoid the total elimination of such entities from economic life, as some of them do pursue honest business activities, boosting the competition and fuelling the banks' efforts to win new business.

Nowadays, banks are faced with the powerful market player that the shadow banking sector has become, a player partly created through their own active participation. Lending operations (loans and borrowings), deposit activities and payment handling services are also in their domain today. A good example is PayPal, which in 2012 handled transfers worth USD 145 billion. In order to compete with that technological company, banks had to reduce their fees for transfers and resign from commissions on online payments. Another good example is Google Wallet – the service for handling payments via NFC phones instead of payment cards. The interchange fee for card transactions in Poland is among the highest in the EU, as it ranges between 1.6% and 1.65%, shared by the bank and the card issuer. Banks must therefore choose: retail chains and long-time co-operants, or Visa and MasterCard. Besides, retail chains also compete with banks. To quote just one example, the Tesco chain in the UK has established its own mini-bank. It issues credit cards, grants consumer and mortgage loans, and accepts deposits. And its business is growing fast⁹.

⁸ Opinia Europejskiego Komitetu Ekonomiczno-Społecznego w sprawie zielonej księgi w sprawie równoległego systemu bankowego COM(2012) 102 final, *Dziennik Urzędowy C 011*, 15/01/2013 P. 0039 – 0043.

⁹ <http://www.obserwatorfinansowy.pl/forma/analizy/banki-wyhodowaly-monstrum-ktore-je-teraz-podgryza/> (31.05.2013).

Table 1. EU regulation in the field of supervision, prudential standards and banking risk management

<p>Banking union (draft):</p> <ul style="list-style-type: none"> - First pillar: Starting from 2014, the ECB will exercise financial supervision over banks in the euro area (the right to license, control and punish banks, as well as to decide on their recapitalisation) - Second pillar: recovery and resolution plan - Third pillar: joint guarantee fund
<p>CRD IV: Capital Requirements Directive - CRD / Capital Requirements Regulation – CRR (adopted by the European Parliament, pending approval of the Council of the EU):</p> <ul style="list-style-type: none"> - implement the provisions of Basel III on the level of EU legislation
<p>Council Regulation (EU) no 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board</p>
<p>Regulation (EU) no 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending decision no 716/2009/EC and repealing Commission decision 2009/78/EC</p>
<p>Regulation (EU) no 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board</p>
<p>Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (amended by: Directive 2009/83/EC; Directive 2009/111/EC; Directive 2010/76/EU).</p> <ul style="list-style-type: none"> - EU banking law - legislation concerning licensing and operations of credit institutions - rules allowing the exercise of prudential supervision over credit institutions - establishment of the consolidated supervision framework - division of supervisory powers between the national supervisory authorities of the home and host Member State - shall be replaced with a CRD IV
<p>Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (amended by: Directive 2009/27/EC; Directive 2009/111/EC; Directive 2010/76/EU):</p> <ul style="list-style-type: none"> - capital adequacy requirements for credit institutions - rules concerning the exercise of prudential supervision over credit institutions - shall be replaced with a CRD IV
<p>Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment companies in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (changes: Directive 2010/78/UE)</p> <ul style="list-style-type: none"> - definition of a financial conglomerate - harmonisation of supervision over financial conglomerates in the EU

Source: Directive 2006/48/EC (OJ L 177 p. 1, 2006); Directive 2006/49/EC (OJ L 177 p. 201, 2006); Directive 2002/87/EC (OJ L 35 p. 1, 2003); Regulation (EU) no 1092/2010 (OJ L 331/1, 2010); Regulation (EU) no 1093/2010 EC (OJ L 331/12, 2010); Council Regulation (EU) no 1096/2010 (OJ L 331/62, 2010); Pawlik K., Droga do CRD IV/CRR. "Bank" 2013, Vol. 5, p. 12.

Obviously, the European Commission can see the existing problem, but it has done little to solve it. The concept of shadow banking emerged in 2007, while the causes were being explored of the current crisis, known as the financial crisis of the 21st century. It was only in 2012 that the Green Paper on Shadow Banking was published, but it is really difficult to find any specific proposals for regulation there. It only indicates some general ways to solve the problem of legislation: indirect regulation of shadow banking activities with the use of regulation concerning banks and insurers; extension of the existing prudential regulation applicable to banks to shadow banking; and direct regulation specifically directed at various types of shadow banking activities. 2012 also saw the completion of the EU shadow banking market overview carried out by the Basel Committee on Banking Supervision (BCBS), International Organisation of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). It is a matter of urgency now to publicise their findings, compile a precise and exhaustive list of activities that need new or improved regulation, and also identify the impact of the proposed regulatory arrangements on the EU financial market (which will not be easy; yet, failing that, the shadow banking sector may be regulated in an incorrect way, which could be even worse for the financial stability than the current lack of regulation of the sector), and only then construct regulatory solutions. It seems, however, that we should not expect appropriate solutions soon, especially as the shadow banking entities are trying to delay the inevitable progress towards the introduction of regulation that will hamper their activities.

Conclusions

There is nothing inherently wrong with the existence of the shadow banking segment. Such entities have their advantages, as their offers complement the banks' product portfolios and fuel competition. Also, there is social demand for such businesses, and, last but not least, their formation is legal. Consequently, any future regulation of their activity cannot lead to the entities' disappearance from the financial market altogether, but only increase the security and stability of their operations by implementing appropriate risk management procedures, adequate prudential standards, and deleveraging. What is highly disturbing is the fact that the entities from the sector discussed here are operating freely and increasing their scale of operations. As a result, they have accumulated unknown sources of risk, thus increasing systemic risk and the extent of irregularities that are now being discovered. This, on the one hand, poses a threat to customers, and, on the other hand, it could lead to the outbreak of another dangerous financial crisis. Given that, it does not seem safe to leave NBFCs outside bank-like regulation and oversight system. If the issues discussed here are resolved, it will also prevent banks from circumventing obligatory prudential standards, and thus put a stop to the risk-generating, out-of-

control and dangerous process of diverting a substantial part of mainstream banking activities to the parallel banking system.

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