CORPORATE GOVERNANCE FOR BANKS

MARTINA MUCHOVÁ

Abstract: *Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Bank´s safety, confidence and soundness are keys to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weakness at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and in the economy as a whole at the same time*[1]*. The governance of individual banks depends crucially on culture. Unfortunately we still see examples of governance failings. Boards have responsibility for shaping the culture, both within the boardroom across the bank as a whole and that requires constant vigilance.*

Keywords: *Financial Crisis, Banks, Corporate Governance, Corporate Culture, Internal Audit*

JEL Classification: *G01, G21, G34, M14, M42*

1. INTRODUCTION

Each crisis in the financial markets brings a wide range of the settings of the new adjustments, rules and regulations. It is easy to look back and correct things in hindsight, but it is important for banks use this opportunity to make positive changes in a period of relative stability, so that they would be ready for the future. The subprime financial crisis evidenced many problems specifically connected with regulations and attitudes of many actors especially in the financial sector. The main fault for the collapse of the financial markets was assigned to banks. In these institutions the weakness and inadequacy of the mechanisms of corporate governance was indicated.

2. PAPER AIMS

This paper aims to present the particularity of the corporate governance of banks and indicate the main distinctions in the bank governance system. The key goal of the paper is the description of the key areas of failure of corporate governance in banks and to present trends of corporate governance in banks.

2.1 Corporate governance

In accordance with OECD definition corporate governance includes: "group relations between company management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which company objectives are set and determined the means to achieve them. Corporate governance should establish appropriate incentives to the Board and management for promoting the objectives of which are in the interest of the company and shareholders and should facilitate effective supervision respectively, control and thus facilitate more efficient use of resources by the banks".[2]

Traditional corporate governance mechanisms, such as concentrated ownership and takeover threats, in principle, also apply to banks. However, banks have special traits and are heavily regulated, preventing natural forms of governance to arise and rendering many of these governance mechanisms ineffective. Financial regulation can in principle compensate for weaknesses in corporate governance but in practice has had limited effectiveness in protecting the interests of banks' stakeholders, because of, for instance, unproductive interactions between regulatory restraints and existing governance arrangements.[3]

Corporate governance determines the allocation of authority and responsibilities by which the business and affairs of a bank are carried out by its board and senior management, including the way of:

a) Setting the bank´s strategy and objectives;
b) Selecting and oversee personnel;
c) Operating the bank´s business on a day-to-day basis;
d) Protecting the interests of depositors, meeting shareholder obligations, and taking into account the interests of other recognized stakeholders;
e) Aligning corporate culture, corporate activities and behavior with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations; and
f) Establishing control functions.

Within a principles based approach and one involving internationally agreed standards as proposed by the OECD and other reputable bodies, local interests and cultural values should be recognized as necessary in supporting growth and development. Good governance should not be seen just a concept relating to the behavior of corporations and markets; good or bad governance goes to the heart of the development process and the way in which economies are administered and to the quality of justice and law - while some essential qualities of governance – trust, integrity, probity – have not changed and are not subject to

[1] http://www.bis.org/press/p141010.htm
[2] KLIMIKOVÁ, M. a kol.2012, ***Bankový manažment a marketing I.***, Bratislava 2012, str. 286, ISBN 978-80-89238-63-7

[3] LAEVEN L., 2013, *Corporate Governance:* ***What's Special About Banks?,*** London, United Kingdom - Research Dpt., International Monetary Fund, Washington, DC 20431, Annual Review of Financial Economics, Vol. 5: 63-92 (Volume publication date November 2013), DOI: 10.1146; http://www.annualreviews.org/doi/full/10.1146/annurev-financial-021113-074421

change, the development process itself and the changing dynamics of markets and industry structures and ownership are clearly necessitate an evolving perspective of governance principles.[4]

2.2 The financial crisis and banking sector

Many factors undoubtedly contributed to the financial crises. Now it is widely recognized that each suffered from a failure in "governance" and in particular a failure in governance in their financial sectors. Financial sector reflects the unique character of financial intermediaries. Financial crises also typically entail large social and economic costs, which are visited not only on the wealthy who have something to loose, but also throughout the populations of countries where employment opportunities dwindle and wages collapse when GDP drops sharply and currency value plummet. The costs of financial crises are not only reasons for being interested in the governance of the financial sector, however. Poor governance is also typically associated with corruption, which not only corrodes the trust individuals have in their private and public institutions, but also in their banks.

Banks are the principal financial intermediaries and are funded mainly by depositors, and thus when banks fail, they can adversely affect household wealth, while possibly leading to systemic losses.

Banks pose a special **governance problem** that is different form ordinary corporations.

- Bank´s activities are more opaque and thus more difficult for shareholders and creditors to monitor.
- The ownership may be dispersed by government regulation and thus takeovers may be impeded, directly or through prohibitions on bank ownership by certain kinds of companies.
- The protection of bank deposits by government deposit insurance program can undercut incentives for depositors to monitor management.

Corporate governance is a cornerstone of the internal control. As a discipline does not only cover relationships and patterns of behavior between management, board, shareholders and other stakeholders of the company, but also includes the way in which the process is implemented in the organization, what is often forgotten. More often the focus is on existence before the effective functioning of corporate governance.

The system of internal controls is not only for large banking corporations, the same principles are applicable to any bank. For small and medium-sized banks, the potential danger is that in the context of corporate governance and internal controls are implemented only the essential, moreover, on an informal basis. Part of the reason may be informal, trust-based relationships in the workplace. However, it is acceptable to apply only informal approach governance, while ensuring the effective functioning of society. It is necessary to set clear and consistent rules.

3. THE PARTICULARITY OF THE BANK´S CORPORATE GOVERNANCE

Corporate governance in banks differs from the standard, which is due to several issues:[5]

- banks are subject to special regulations and supervision by state agencies (monitoring activities of the bank are therefore mirrored); supervision of banks is also exercised by the purchasers of securities issued by banks and depositors ("market discipline", "private monitoring");
- the bankruptcy of a bank raises social costs, which does not happen in the case of other kinds of entities' collapse; this affects the behavior of other banks and regulators;
- regulations and measures of safety net substantially change the behavior of owners, managers and customers of the banks; rules can be counterproductive, leading to undesirable behavior management (take increased risk) which expose well-being of stakeholders of the bank (in particular the depositors and owners);
- between the bank and its clients there are fiduciary relationships raising additional relationships and agency costs;
- problem principal-agent is more complex in banks, among others due to the asymmetry of information not only between owners and managers, but also between owners, borrowers, depositors, managers and supervisors;
- the number of parties with a stake in an institution's activity complicates the governance of financial institutions.

To summarize, depositors, shareholders and regulators are concerned with the robustness of corporate governance mechanisms. In the case of banks therefore, corporate governance needs to be perceived as a need of such conduct of an institution, which would force the management to protect the best interests of all stakeholders and ensure responsible behavior and attitudes (Tirole, 2001). Corporate fairness, transparency and accountability are thus the main objectives of corporate governance, taking into account the corporate "democracy", which is the broad participation of stakeholders (R.E. Basinger et al., 2005)[6].

One must have in mind that **there is no one model of corporate governance** adaptable to all banks. Other goals, and therefore supervisory systems, will be in banks: private, cooperative and state; in the local and global banks; universal banks and investment, though priorities remain the same. In the banking sector corporate governance is therefore a way of business and affairs of the bank by the management and the board, affecting how they[7]:

- define the objectives and goals;
- lead current bank activities;

[4] WALLER K., 2006, ***Promoting Good Corporate Governance and Transparency in APEC Financial Institutions Coordinator,*** ABA Journal – Vol. XXI, No. 1, 2006, http://www.aba.org.tw/images/upload/files/GoodCorporateKenWaller.pdf

[5] MARCINKOWSKA M., 2012, ***Corporate Governance in banks: Problems and remedies****, DOI: 10.5817/FAI2012-2-4

[6] OECD Principles of Corporate Governance; Organization for Economic Co-operation & Development; 2004

[7] Bank for International Settlements – Basel Committee on Banking Supervision; Consultative Document „Enhancing corporate governance for banking organizations"; Issued for comment by 31 October 2005; July 2005 (http://www.bis.org/publ/bcbs117.pdf)

- fulfill the obligation of accountability to shareholders and take into account the interests of stakeholders;
- apply the requirement to operate safely and to ensure a good financial situation and
- compliance with applicable regulations;
- protect the interests of depositors

Shortcomings in the governance of large financial groups have indicated that these may indirectly trigger systemic risks. Regulators and financial supervisors take action to ensure an individual bank's stability; in the case of systemically important banks this would result in the pursuit of overall financial stability. The main issues of corporate governance matters with specific systemic impact are: the "gatekeepers" (esp. auditors and credit rating agencies), corporate values and codes of conduct of banks, risk management and internal governance of banks managerial incentives to act in an appropriate manner, accounting (and valuation) rules.[8]

Moreover, there is some scepticism about the effectiveness of the "comply or explain" approach to corporate governance[9]. As pointed out by the European Commission, the "comply or explain" approach would work much more effectively if specific monitoring bodies were entitled to check whether the available information, in particular the explanation has an appropriate informative value and is appropriately broad. It is emphasized, however, that these institutions should not interfere with the content of the information disclosed or evaluate the solutions adopted by the company – it should still be a task left to the market[10].

4. KEY AREAS OF FAILURE OF CORPORATE GOVERNANCE IN BANKS

A key issue in finance and investment management is the understanding and practice of **ethical norms**. If we closely analyze the recent financial turmoil, we will certainly find misconduct of ethical norms by a few leading market participants that ultimately translated into market panic and subsequently crash. Among many other factors, the global financial crisis and domestic turbulence can also be attributed underlying weaknesses in how corporate governance is practiced and **losing of confidence.** Internationally, the prevailing corporate governance practices failed to safeguard against excessive risks taken by leading financial institutions.[11] The confidence of the public in a bank and the entire banking system is necessary for a proper functioning of the financial system and economy. Effective corporate governance practices are fundamental to gain and maintain this confidence[12].

4.1 Confidence

Good governance promotes competition in markets through highest standards of disclosure and it also promotes innovation and risk taking in well regulated markets. Good governance in central banks and banking supervisory agencies must support their commitment to maintaining financial system stability and their legitimacy empowered by law. The central bank should act independently in the conduct of monetary policy.

The confidence is a basic prerequisite for a proper functioning of banks. It is necessary to carry out fundamental reforms that will bring inner harmony and allow find the lost of the public confidence. Therefore, an in-depth analysis of the recent crisis causes should be done. Particularly considering that the rules of proper conduct of banking business exist and are being implemented, but it is mainly the deficiencies in corporate governance which are to blame for the recent financial crisis[13]. This raises the question: Were the rules inadequate or poorly implemented?

- *the role, tasks and responsibilities of the board*, as well as its size, organization and member´s composition and the functioning of this body and the assessment of its work;

There are a number of requirements for members of the supervisory board of a bank. An absolute requirement is that they have high qualifications, clearly understand their role in the supervision of the bank and are able to assess the matter in a balanced manner. This is the first rule of effective corporate governance in banks, published by the Basel Committee on Banking Supervision[14]. It is therefore necessary to ensure that the board of the bank consists of persons with great professionalism (adequate knowledge, skills, commitment, experience, constantly upgrading their skills).

Members of the board must be able to spend enough time performing their tasks, which is not limited to participation in the meetings of the board and its committees. It is important that members of the board should perform their duties with engagement, but it is not recommended that they take part in the operational management[15].

- *control of bank risk exposure;*

[8] WYMEERSCH E., 2008, ***Citi considerations on the draft advice on UCITS Management Company Passport and on the Consultation paper on risk management principles for UCITS,*** Paris, 23. October 2010, 12 pgs http://www.esma.europa.eu/system/files/Citi_feedback_on_MCP_and_RMP.pdf

[9] Financial Reporting Council, ***Comply or Explain***, 20th Anniversary of the UK Corporate Governance Code https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Comply-or-Explain-20th-Anniversary-of-the-UK- Corpo.aspx

[10] European Commission 2011, ***The EU corporate governance framework***, Brussels, Green Paper, COM(2011) 164 final http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf

[11] ANWAR Y., 2012 ***Ethics, corporate governance and financial inclusion***; Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the Chartered Financial Analyst (CFA) Convention and Excellence Awards ceremony, Karachi, 4 July 2012, http://www.bis.org/review/r120727a.pdf

[12] Bank for International Settlements – Basel Committee on Banking Supervision; Consultative Document „Enhancing corporate governance for banking organizations"; Issued for comment by 31 October 2005; July 2005 (http://www.bis.org/publ/bcbs117.pdf)

[13] ADAMS R. B., 2009, ***Governance and the Financial Crisis***, European Corporate Governance Institute, Finance Working Paper No.248/2009, May 4, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1398583

[14] Bank for International Settlements – Basel Committee on Banking Supervision; Consultative Document „Enhancing corporate governance for banking organizations"; Issued for comment by 31 October 2005; July 2005 (http://www.bis.org/publ/bcbs117.pdf)

[15] Bank for International Settlements – Basel Committee on Banking Supervision; Consultative Document „Enhancing corporate governance for banking organizations"; Issued for comment by 31 October 2005; July 2005 (http://www.bis.org/publ/bcbs117.pdf)

- *evaluation of executives and its incentive pay;*
- *transparency of the bank supervisory board* that allows for the assessment of its activities
- *ownership structure of banks* and the role of institutional investors. In order to avoid a similar financial crisis in the future, regulators of financial markets are planning to establish standards for sealing the system in these areas.

4.2 Ethics

The ethics – there is also no doubt that the basic element of the improved governance of the financial market should be ethics.[16] It is unrealistic to expect that the supervision and private monitoring of complex financial markets and institutions may be based solely on regulations, but this neither means that the state may exempt from these processes.

Ethical principles commonly serve as regulators of human behavior. In the global economy current developments once again underlines the need for the application of ethical principles into the management mode of the organization. Due to the increasing pressure of competing influences individuals often relaxes the ethical principles in anticipation of personal or material gain. It should also be borne in mind that in this situation, individuals are willing to accept even higher level of risk. Especially, when they are entrusted with the administration and management of foreign assets, often they tend to dispose of riskier than own assets. The moment you are favored targets and increasing pressure on staff leads to suppression not only of individual morality, but also the ethical principles of the enterprise.

Shareholder pressure and keeping the good business results often puts individuals into difficult situations. The effect of temperature significantly affects the behavior to the extent that the desired results tense atmosphere at all costs to the likelihood morally wrong decisions. In banks with developed structure of internal controls, many ethical issues already covered in the standards that form the "backbone" organizational and legal structure of the bank. A good example can be controls that prevent corrupt behavior is the organization of tender procedures or controls relating to the approval process of remuneration.

5. TRENDS IN CORPORATE GOVERNANCE FOR BANKS

Unless the relevant processes and their controls do not lead to the detection of symptoms of unethical behavior, it is necessary to provide a complete range of procedures and rules that simply define which behavior is and is not acceptable.

The current trend is the promotion of the so-called, ***whistle-blowing***, when the employees and interested parties allowed to anonymously report instances of unethical behavior.

Still important tool is ***the ethical code*** that employees familiar and agree on it. This simple step is a clear sign that the employer has a serious interest in complying with ethical principles. The question of whether it is important to consider ethics in economic terms, is quite essential. Is there a difference unless someone wrongly obtained amount of money to adopt a child or a million-dollar bribe in order to benefit a particular company in the selection process? The difference between the examples is in their material substance, but in both cases it is an ethical violation. Tolerance to small offenses is common, but dangerous, because at the same time serves as a signal that unethical behavior is tolerated to some extent. As a result disparage ethical standards and all the more so the more tolerance grows to petty offenses.

The other trend is a process of ***assurance.*** In fact, the lines that such a process should follow have not yet been clearly established because the responsibility of the internal auditor shifts from the verification of purely quantitative data after the fact to providing assurance on the management and disclosure processes that the organization has followed with regard to the issue of materiality. In future the abilities and experience of internal auditors shall be called on to make a contribution and provide support for issuing assurances on social and environmental aspects as well.[17]

Finding the right balance between the internal audit function assurance services and consulting engagements requires an explicit strategy that should be determined by the audit committee or equivalent on behalf of the organization. The audit committee determines how much assurance is needed in each engagement, plans it appropriately, and finds the right resources to complete the task. Consulting and assurance engagements of internal audit functions are important and valuable to an organization.[18]

The ***sustainability*** has been identified as a major strategic topic too. Although most auditor leaders agree that governance changes and improved communication are needed to provide better transparency and leadership. Financial institutions would benefit by developing a sustainability management and reporting framework, which covers, but is not limited to, identification of material issues and risks, conducting stakeholder engagements as well as environment, health safety and social audits, mapping the carbon footprint of a bank´s operations and developing sustainability reports. Banks and financial institutions should also consider adding further credibility to their sustainability reports through independent third-party assurance for data as well as statements and claims in these.

6. CONCLUSION

The financial crisis highlighted corporate governance´s importance to financial institutions, including banks. Recent evidence shows that inadequate board oversight, weak internal controls and insufficient supervisory emphasis on corporate governance were detrimental to the safety and confidence in banking sector. Governance in banks is a considerably more complex issue than in other sectors.

---

[16] European Commission 2010, ***Corporate Governance in financial institutions and remuneration policies***, Brussels, Green Paper, COM (2010) 284 final http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf

[17] European Governance, 2014, The Official Magazine of the ECIIA, May 24, 2014, Issue 26, http://www.interniaudit.cz/download/ECIIA/ECIIA-Magazine-May-2014.pdf

[18] The Institute of Internal Auditors Research Foundation, ***Common Body of knowledge Survey data***, 247 Mainland Avenue, Altamonte Springs Florida 32701- 4201, http://www.interniaudit.cz/download/CBOK/1582416_5010.1- Characteristics-of-an-IA-activity.pdf, ISBN 978-0-89413-695-5

Banks will attempt to comply with the same codes of board governance as other companies but, in addition, factors like risk management, capital adequacy and funding, internal control, and compliance all have an impact on their matrix of governance.[19]

Corporate governance is also a curiously two-sided issue for banks since their funding and, often, ownership of other companies makes them a significant stakeholder in their own right. No governance framework can eliminate risk and nor should it seek to do so. The difficult question of what represents an acceptable level of corporate failure will always be actual. We should continue to seek new ways to prevent and deal with poor governance practice.

REFERENCES

[1] ADAMS R. B., 2009, ***Governance and the Financial Crisis***, European Corporate Governance Institute, Finance Working Paper No.248/2009, May 4, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1398583

[2] ANWAR Y., 2012 ***Ethics, corporate governance and financial inclusion***; Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the Chartered Financial Analyst (CFA) Convention and Excellence Awards ceremony, Karachi, July 4, 2012, http://www.bis.org/review/r120727a.pdf

[3] Bank for International Settlements – Basel Committee on Banking Supervision; Consultative Document „Enhancing corporate governance for banking organizations“; Issued for comment by 31 October 2005; July 2005 (http://www.bis.org/publ/bcbs117.pdf)

[4] European Commission 2010, ***Corporate Governance in financial institutions and remuneration policies***, Brussels, Green Paper, COM (2010) 284 final http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf

[5] European Commission 2011, ***The EU corporate governance framework***, Brussels, Green Paper, COM (2011) 164 final http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf

[6] European Governance, 2014, The Official Magazine of the ECIIA, May 24, 2014, Issue 26, http://www.interniaudit.cz/download/ECIIA/ECIIA-Magazine-May-2014.pdf

[7] Financial Reporting Council, ***Comply or Explain***, 20th Anniversary of the UK Corporate Governance Code, https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Comply-or-Explain-20th-Anniversary-of-the-UK-Corpo.aspx

[8] KLIMIKOVÁ, M. a kol.2012, ***Bankový manažment a marketing I.***, Bratislava 2012, pg 286, ISBN 978-80-89238-63-7

[9] LAEVEN L., 2013, ***Corporate Governance: What's Special About Banks?,*** London, United Kingdom - Research Dpt., International Monetary Fund, Washington, DC 20431, Annual Review of Financial Economics, Vol. 5: 63-92 (Volume publication date November 2013), DOI: 10.1146; http://www.annualreviews.org/doi/full/10.1146/annurev-financial-021113-074421

[10] MARCINKOWSKA M., 2012, ***Corporate Governance in banks: Problems and remedies****, DOI: 10.5817/FAI2012-2-4

[11] OECD Principles of Corporate Governance; Organization for Economic Co-operation & Development; 2004

[12] ROMERO, A., 2003, ***The need for Corporate Governance in averting banking crises -Lessons from the Banco Latino Crisis,*** Speech delivered by Drs. Alberto G. Romero; Executive Director Bank van de Nederlandse Antillen at the KPMG banking seminar in the Dominican Republic, October 2, 2003, http://www.centralbank.an/index.php?eid=1938

[13] The Institute of Internal Auditors Research Foundation, ***Common Body of knowledge Survey data***, 247 Mainland Avenue, Altamonte Springs Florida 32701- 4201, http://www.interniaudit.cz/download/CBOK/1582416_5010.1-Characteristics-of-an-IA-activity.pdf, ISBN 978-0-89413-695-5

[14] WALLER K., 2006, ***Promoting Good Corporate Governance and Transparency in APEC Financial Institutions Coordinator,*** ABA Journal – Vol. XXI, No. 1, 2006, http://www.aba.org.tw/images/upload/files/GoodCorporateKenWaller.pdf

[15] WYMEERSCH E., 2008, ***Citi considerations on the draft advice on UCITS Management Company Passport and on the consultation paper on risk management principles for UCITS,*** Paris, October 23, 2010, 12 pgs http://www.esma.europa.eu/system/files/Citi_feedback_on_MCP_and_RMP.pdf

[16] http://www.bis.org/press/p141010.htm

Ing. Martina MUCHOVÁ[19]
Ekonomická univerzita v Bratislave, Národohospodárska fakulta, Katedra bankovníctva a medzinárodných financií
Dolnozemská cesta 1, 852 35 Bratislava, Slovakia
e-mail: flymatus@gmail.com

[19] ROMERO, A., 2003, ***The need for Corporate Governance in averting banking crises -Lessons from the Banco Latino Crisis,*** Speech delivered by Drs. Alberto G. Romero; Executive Director Bank van de Nederlandse Antillen at the KPMG banking seminar in the Dominican Republic, October 2, 2003, http://www.centralbank.an/index.php?eid=1938