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Abstract
The threat of systemic risk in international financial markets necessitates the establishment of universal standards for corporate governance of financial institutions. This paper addresses some important issues and concepts in the governance of multinational financial institutions and why international standards are needed to guide financial institutions in assessing and protecting against risk in financial markets. It acknowledges that different structural approaches to corporate governance exist across countries, and encourages practices which can strengthen corporate governance under diverse structures. An important task for supervisors and regulators is to ensure that incentives exist to encourage senior bank management to adopt good regulatory practices that approximate the economic risk exposure of the financial institution. This paper analyses corporate governance within framework of international financial markets and how international standards can be applied in a way that can effectively reduce systemic risk.

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1. Introduction

Global financial systems have undergone marked structural changes during the last few decades as a result of various forces including deregulation, technological change, and financial innovation. These factors have changed the environment within which financial firms operate and the ways in which activities have been undertaken. Given the central role of financial institutions and markets to society as a whole, the conduct of such financial intermediaries and the environment in which they operate remains particularly important. In this light, it has been argued that the forces of financial reform and structural adjustment have generally paid inadequate attention to governance issues for financial institutions. This paper hopes to fill this gap by discussing standards of governance for and within financial institutions.

The analysis in this paper recognises that there are significant differences in the legislative and regulatory frameworks across countries with respect to the functions of the board and senior management. For example, in some legal systems, the company board is known as a supervisory board. This means that the board has no executive functions. By contrast, in other legal systems, the board exercises broader powers insofar as it has the authority to establish the general framework for management of the company. Due to these differences, the notions of boards of directors and senior management are not used to identify legal constructs, but rather to describe and explain two types of decision-making functions within a bank. These different types of functions, which are known as corporate governance functions, will be discussed along with sound practice strategies that underscore the need for banks to adopt strategies for their operations and to establish accountability for implementing these strategies.

The paper also discusses the major principles of corporate governance for financial institutions as set forth by the G10Basel Committee. The influence of the Basel Committee in setting standards of financial regulation for advanced economies suggests that these principles of corporate governance will likely become international standards that will be implemented into the regulatory practices of the leading industrial states. Although the globalisation of financial markets necessitates some basic international standards of corporate governance for financial institutions, we also recognise that such uniform international standards may result in different types and levels of systemic risk for different jurisdictions because of differences in business customs and practices and the institutional and legal structures of national markets. We argue therefore that the adoption of international standards and principles of corporate governance should be accompanied by domestic regulations that prescribe specific rules and procedures for the governance of financial institutions that address national differences in political, economic and legal systems.

The paper begins by briefly considering 'governance' within this context using a *principal-agent* framework. It then discusses the general principles of corporate governance for financial institutions that the Basel Committee has adopted for all banking institutions operating in the G10 industrialized countries. The overriding theme is based in the belief that transparency of information is integrally related to accountability in that it could provide government supervisors, bank owners, creditors, and other market participants sufficient information and incentive to assess the management of a bank. The paper concludes by considering these and other issues related to the governance role of financial institutions in the overall economy.

2. Background

Corporate governance for all institutions including financial intermediaries has become an important issue in various national and

international fora. In 1997, the Organisation for Economic Co-operation and Development (OECD) issued a set of corporate governance standards and guidelines to assist governments in their efforts to evaluate and improve the legal, institutional, and regulatory framework for corporate governance in their countries. The OECD guidelines also provide standards and suggestions for stock exchanges, investors, corporations, and other parties that 'have a role in the process of developing good corporate governance.[1] Such corporate governance standards and structures are especially important for banking institutions that operate on a global basis. To this extent, the OECD principles may serve as a model to be applied to the governance structure of multinational financial institutions.

The OECD suggests that sound corporate governance of financial institutions needs to be in place in order for banking and financial supervision to operate effectively. Consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organisation. Supervisory experience underscores the necessity of having appropriate levels of accountability and managerial competence within each bank. Essentially, the effective supervision of the international banking system requires sound governance structures within each bank, especially with respect to multi-functional banks that operate on a transnational basis. A sound governance system can contribute to a collaborative working relationship between bank supervisors and bank management.

Even the Basel Committee has recognised that the primary responsibility for good corporate governance rests with boards of directors and senior management of banks. But theBasel Committee's 1999 Report on Corporate Governance also suggests that there are other ways that corporate governance can be promoted, including:

(1) governments – through laws and regulations;
(2) securities regulators and stock exchanges, through disclosure and listing requirements;

(3) accounting standards – through audit standards on communications to board of directors, senior management and on publication of sound practices;
(4) banking industry associations – through initiatives related to voluntary industry principles and agreement on publication of sound practices.[2]

In this respect, the role of legal issues is crucial for determining ways to improve corporate governance for financial institutions. For example, the enforceability of contracts, including those with service providers; clarifying governance roles of supervisors and senior management; ensuring that corporations operate in an environment that is free from corruption and bribery; and laws/regulations (and other measures) aligning the interests of managers, employees and shareholders, all help promote a strong business and legal environments that support corporate governance and related supervisory activities.

3. The Uniqueness of Banking Regulation

The role of banks is integral to any economy. They provide financing for commercial enterprises, access to payment systems, and a variety of retail financial services for the economy at large. Some banks have a broader impact on the macro sector of the economy by facilitating the transmission of monetary policy by making credit and liquidity available in difficult market conditions.[3] The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing, in many cases, a government safety net to compensate depositors when banks fail. Financial regulation is necessary because of the multiplier effect that banking activities have on the rest of the economy. The large number of stakeholders (such as employees, customers, suppliers etc), whose economic well-being depends on the health of the banking industry, depend on appropriate regulatory practices and supervision. Indeed, in a healthy banking system, the supervisors and regulators themselves are stakeholders acting on behalf of society at

large. Their primary function is to develop substantive standards and other risk management procedures for financial institutions in which regulatory risk measures correspond to the overall economic and operational risk faced by a bank. Accordingly, it is imperative that financial regulators ensure that banking and other financial institutions have strong governance structures, especially in light of the pervasive changes in the nature and structure of both the banking industry and the regulation which governs its activities.

4. Governance: Principal-Agent Problem

The main characteristics of any governance problem are that the opportunity exists for some managers to improve their economic payoffs by engaging in unobserved, socially costly behaviour or 'abuse' and the inferior information set of the outside monitors relative to the firm.[4] These characteristics are related since abuse would not be unobserved if the monitor had complete information. The basic idea – that managers have an information advantage and that this gives them the opportunity to take self-interested actions – is the standard *principal-agent* argument. The more interesting issue is how this information asymmetry and the potential for resulting inefficiencies affect governance within financial institutions. Does the manager have better information? Perhaps the best evidence that monitors possess inferior information relative to managers lies in the fact that monitors often employ incentive mechanisms rather than relying completely on explicit directives alone.[5]

There is a wide range of potential agency problems in financial institutions involving several major stakeholder groups including but not limited to shareholders, creditors/owners, depositors, management, and supervisory bodies. Agency problems arise because responsibility for decision making is directly or indirectly delegated from one stakeholder group to another in situations where objectives between stakeholder groups differ and where complete information which would allow further control to be exerted over the decision maker is not readily available. Some of the most studied agency

problems in the case of financial institutions are those involving depositors and shareholders or supervisors and shareholders. While that perspective underpins the major features of the design of regulatory structures (capital adequacy requirements, deposit insurance, etc.), problems of incentive conflict between management and owners have become a focus of recent attention.[6]

The resulting view that financial markets can be subject to inherent instability induces governments to intervene to provide depositor protection in some form or other. Explicit deposit insurance is one approach while explicit or implicit deposit guarantees is another. In either case, general prudential supervision also occurs to limit the risk incurred by insurers or guarantors. To control the incentives of bank owners who rely too heavily on government funded deposit insurance, governments typically enforce some control over bank owners. These can involve limits on the range of activities; linking deposit insurance premiums to risk; and aligning capital adequacy requirements with business risk.[7] While such controls may overcome the agency problem between government and bank owners, it must be asked how significant this problem is in reality. A cursory review of recent banking crises would suggest that many causes for concern relate to management decisions which reflect agency problems involving management. Management may have different risk preferences from those of other stakeholders including the government, owners, creditors, etc., or limited competence in assessing the risks involved in its decisions, and yet have significant freedom of action because of the absence of adequate control systems able to resolve agency problems.

5. The Role of the Stakeholder

The extent to which excessive risk taking is limited by governance mechanisms as practised by the supervisory authority or even the market greatly affects the behaviour of financial institutions. In this light, there seem to be three potential groups which can monitor the management of banks: owners, market, and supervisors. The main

question and the focus of this paper is how governance processes can ensure that each of the above is able to exert sufficient pressure on managers to avoid excessive risk taking. In more developed financial markets, authorities use several measures including erecting entry barriers, enforcing modest capital requirements at or above the minimum 8% Basel Committee capital to risk-weighted assets ratio, facing market discipline in money and capital markets which are usually uncovered by explicit government guarantees, and being supervised by one or more of the supervisory agencies.

The same risks encountered by supervisory authorities in emerging markets are even greater due in some part to the small and often more concentrated nature of their economies, where shocks are often larger and more volatile, and where the market's ability to monitor banks is hampered by poorer information. Thus, in both industrialised and developing markets, governance mechanisms need to be enhanced to encourage each of the potential monitoring groups to curb excessive risk taking activities by banks. The following sections will briefly consider the role of owners, market, and supervisors in further refining governance mechanisms within financial institutions.

6. Basel Committee and Corporate Governance Standards

The Basel Committee has issued several papers in recent years addressing specific topics on corporate governance for financial institutions. The most important of these reports are: *Principles for the Management of Interest Rate Risk*[8], *Framework for Internal Control Systems in Banking Organisations*[9], *Enhancing Bank Transparency*[10], and *Principles for the Management of Credit Risk*.[11] These reports highlight the essential strategies and techniques for sound corporate governance at financial institutions. The corporate governance standards espoused by these reports can be summarised as follows:

a) the establishment of strategic objectives and a set of corporate values that are communicated throughout the banking organisation;

b) setting and enforcing clear lines of responsibility and accountability throughout the organisation;

c) ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns;

d) ensuring that there is appropriate oversight by senior management;

e) effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide;

f) ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment;

g) conducting corporate governance in a transparent manner.

These standards recognise that senior management is an integral component of the corporate governance process, while the board of directors provides checks and balances to senior managers, and that senior managers should assume the oversight role with respect to line managers in specific business areas and activities. The effectiveness of the audit process can be enhanced by recognising the importance and independence of the auditors and requiring timely correction by management of problems identified by auditors. The organisational structure of the board and management should be transparent with clearly identifiable lines of communication and responsibility for decision making and business areas. Moreover, there should be

itemization of the nature and extent of transactions with affiliates and related parties.[12]

7. Governance by Owners, Supervisors, and Market Participants

Investors or owners who own equity in a bank in principle have both the ability and the incentive to monitor the actions of their bank. As rational agents, they tend to provide effective self-regulation when they have much at risk either in the form of capital and/or future expected profits. Moreover, well capitalised banks are usually better monitored by their shareholders. On the other hand, small shareholders might tend to free ride, so it is important that government make sure that there are large stakeholders or strategic investors who will bear greater responsibilities. Inside and outside investors need to face the loss of their investment, and they and their managers need to realise the very real possibilities of bank failure or exit from the industry to discourage excessive risk taking activities.

In this light, some emerging markets have raised their minimum capital ratios above that for many industrialised countries to account for the riskier environments in which they operate. For example, in Argentina, the minimum capital adequacy ratio is 11.5%, with even higher requirements for banks engaging in riskier activities and weaker risk management capacity. Moreover, banks in most countries with 8% capital adequacy requirements usually have capital ratios in excess of the minimum criteria, e.g., the U.S. has an average capital ratio of almost 12%.[13] Even then, capital adequacy ratios are by nature backward looking accounting indicators of the solvency of financial institutions. The demise of banks with high measured capital ratios has not been an uncommon occurrence (Dhumale, 2000).

The increased incentives to engage in excessive risk taking when the capital adequacy position is weakened makes it even more important not to rely on capital adequacy alone. Many countries have relied on various measures from limiting entry to enhancing the liability of

directors and shareholders to the issuance of subordinated debt. While some of these methods may be relatively blunt, the costs of not using them can be quite high. Owners of financial institutions will behave more prudently, i.e., be more risk averse, if they have more to lose in the form of capital, future expected revenue, profits, etc., Similarly, supervisors need to be able both to monitor and enforce any discrepancies they reveal through their evaluations. Finally, deposit holders tend to provide better market discipline if they are not always fully covered by implicit or explicit deposit insurance schemes.

With the appropriate abilities, market participants who enter into creditor relationships with banks could serve as monitors. Their ability to monitor would depend on the quality and quantity of information they receive which, in turn, would depend on the quality of accounting standards and practices. To solve the information requirements, some countries have recently enacted extensive disclosure requirements supported by greater liabilities, mandatory ratings by at least two private ratings agencies, and an online credit reporting system as in New Zealand, Chile, and Argentina respectively. In addition to information, creditors need the appropriate incentives to monitor market practices such as the possibility that they will be allowed to suffer losses. Although small depositors are unlikely to be good monitors of banks, large debt holders are better equipped to fulfil this role. One example of using such incentives has been the mandatory issuance of subordinated debt by banks so that if the current owners of a bank fail in ensuring a safe and sound bank, the subordinated holders can take over the bank. A more detailed discussion of this type of proposal will follow in the next section.

In the early years, bank supervision mostly involved ensuring compliance with government directives on credit allocation and other issues. However, today most regulatory authorities have moved to engage in prudential supervision as their main task. The question still remains of providing the appropriate incentives both to monitor and to take actions based on the observations of the supervisors. To begin, supervisors need sufficient compensation to attract qualified

personnel so that they are not lured into moving to the private sector. Moreover, the temptation of such high paying private sector jobs might lead to possible corruption where one may accept lower pay now in exchange for a lucrative salary later. The disincentive for effective supervision can only be reduced by raising supervisory pay at least close to private sector limits. Efforts have been made to create 'bonded regulators' so that some portion of a supervisor's compensation is deferred and held as a bond from which deductions can be taken depending on the outcome in the financial sector.[14] Another measure might be to limit the possibility of supervisors to switch to the private sector for a certain period following their employment with the supervisory agency.[15]

Finally, recommendations have also been made to commit supervisors to a certain course of action in advance such as 'prompt corrective actions' and 'structured early intervention approaches.' Such intervention includes higher capital; structured and pre-specified publicly announced responses by regulators triggered by decreases in a bank's performance below established criteria; mandatory resolution of a capital depleted bank at a pre-specified point when capital still exists; market value accounting and reporting of capital. The main problem with the establishment of such pre-fixed rules is that governments may be tempted to re-write them during difficult times, as witnessed even in highly industrialised countries, such as Japan in 1997-98 (deferred scheduled deregulation), and the U.S. in the 1980s (replacing the GAAP for S & Ls with less stringent accounting standards that calculated good will as an asset for capital adequacy purposes).

8. Conclusion

Many observers agree that the banking industry is one sector which has been greatly affected by major structural changes, due in part to the pressures of increased globalisation. The consequences of such changes include but are not limited to increased competition, squeezed profit margins, and intense pressure to cut prices and

quickly develop and market new products with shorter life cycles – all with significantly shorter turnaround times. In addition, the banking industry has been subjected to the competitive forces of deregulation in both their activities and prices. The 'internationalisation' of financial markets necessitates the establishment of universal standards of corporate governance for financial institutions. These standards include but are by no means limited to: a) enhanced monitoring; b) improved disclosure and accounting practices; c) better enforcement of corporate governance rules and the corporate governance framework; and d) strengthening institutions through market discipline.

This paper acknowledges that different structural approaches to corporate governance exist across countries, and encouragespractices which can strengthen corporate governance under diverse structures. To improve the structure of, and framework for, such institutions to operate effectively, an important task for supervisors and regulators is to ensure that incentives exist to encourage senior bank management to adopt good regulatory practices that approximate the economic risk exposure of the financial institution. Because different national markets will have different types of economic risk to protect against, there will be no universally correct answers that account for differences in financial markets and that laws need not be uniform from country to country. Recognising this, sound governance can be practised regardless of the form used by a banking organisation. The organisational structure of any bank, however, should include four forms of oversight: (1) oversight by the board of directors or supervisory board; (2) oversight by non-executive individuals who are not involved in the day-to-day managing of the business; (3) direct line supervision of different business areas; and (4) independent risk management and audit functions. Regulators should also utilise appropriate criteria to ensure that key personnel meet fit and proper standards. These principles should also apply to government-owned banks, but with the recognition that government ownership may often mean different strategies and objectives for the bank.

Notes

[1] See 'OECD Principles of Corporate Governance' issued 21 June, 1999, www.oecd.org.

[2] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* (1999) p. 3.

[3] P. Turner (2000), 'Procyclicality of regulatory ratios?' A Paper presented at Queens' College, Cambridge, January 2000; prepared for the Ford Foundation project on 'A World Financial Authority'.

[4] A. Shleifer & R. Vishny (1997) 'A Survey of Corporate Governance', *Journal of Finance*, p. 741.

[5] Such incentive mechanisms may take the form of tying a portion of a manager's compensation to the company performance in the stock market through the use of stock options, for example.

[6] See, for example, Prowse (1995).

[7] See *Second Consultative Paper* of the *New Basel Accord* (Jan. 16, 2001) for more details on attempts to align regulatory capital with economic risk.

[8] (September 1997) www.bis.org.

[9] (September 1998) www.bis.org.

[10] (September 1998) www.bis.org.

[11] (July 1999) www.bis.org.

[12] The International Accounting Standards Committee defines related parties as 'controlling' parties who are 'able to control or exercise significant influence. Controlled relationships include: (1) parent-subsidiary; (2) entities under common control; (3) associates; (4) individuals who through ownership have significant influence over the enterprise and close members of their families; and (5) key management personnel. See IASC, International Accounting Standard No. 24, *Related Party Disclosures*.

[13] See 12 C.F.R. part 225.90, Regulation Y (Federal Reserve System). Moreover, the Financial Services Modernization Act of 1999 requires Financial Holding Companies to maintain 6% for Tier 1 capital and 4% for Tier 2 capital, resulting in a 10% capital to risk-based assets ratio. Pub. L. No. 106-102, Nov. 12, 1999, 113 Stat. 1338 (1999), 12 C.F.R. part 225.90.

[14] For further information, see the Suffolk banking system in the U.S. between 1820-1850 (C. Calomiris and C. Kahn [1996] 'The Efficiency of Self-Regulated Regulated Payments Systems: Learning from the Suffolk System' N.B.E.R. Working Paper 5442 (www.nber.org.org/papers/w7265; see also, Smith, R.A., and W. Weber [1998] 'Lessons from Laissez-Faire Payments System: The Suffolk Banking System [1825-58]' Review, Federal Reserve Bank of Minneapolis, 80:105-20).

[15] For example, in the U.S., bank supervisors who have reached a certain level of seniority are not permitted to take a job with a commercial bank they have supervised until a period of 12 months has lapsed after their service.

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