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Boards should not escape the Basel shake-up

Regulation is unlikely to deliver financial stability if it is forever chasing what market practitioners are doing. In the 10 years since background work on Basel II started, there has been change in the structure of banking, in the products it supplies and in the techniques of "financial engineering" that it employs. The pace of change is unlikely to relent.

In banking, regulation must encourage stability-promoting practices that spring out of the process of financial innovation itself. It must, in short, encourage good governance. When governance is weak, the risk of financial instability creeps in. In situations where supervision is also weak, as in most developing countries, financial crises erupt.

To some extent, regulators are already looking beyond direct supervision. They have started to rely on the watchfulness and actions of uninsured bank counterparties in the interbank, derivatives and corporate bond markets. Because banking is more highly leveraged than any other industry, these are likely to be effective monitors. A cut in willingness to extend credit to a bank, or to treat it as an acceptable counterparty, will compel management to respond. But this has produced a corporate governance structure peculiar to banking: shareholder-driven discipline is the least important pressure for stability, rather than the most important.

Bank supervision is modelled after this "upside-down" governance structure: supervisors usually deal with bank management and rarely meet boards, which they tend not to regard as the ultimate locus of accountability. But this weakens even further shareholders' and directors' incentives for remedial action and shifts more responsibility on to supervisors. No wonder that Basel II's methods can readily be summarised, only a little unkindly, as a typical regulator's solution – more detailed regulation and more and more intrusive, supervisory intervention.

In parallel with Basel II's emphasis on risk measurement and supervisory review, a crucial aspect of regulation should be to ensure that banks have effective governance structures. This would mean that the interests of directors and shareholders are aligned with those of supervisors. Appraised in such terms, the present governance process has substantial defects. Banks may be tempted to take excessive risks to get out of difficulties: they will, after all, keep any gains and if things go wrong supervisors may well intervene before all is lost. Selling off bits of the business is always a tempting route out of serious problems but, all too often, that means selling the best bits first, so decline becomes entrenched.

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What should be done? First, supervisors should commit to formal procedures for disclosing their actions to help shareholders and creditors. They should share parts of their analyses, including their assessment of board effectiveness, with shareholders and boards to help them take remedial action early. Effective relations with shareholders and board members can be critical: without an ongoing dialogue, it is harder for supervisors to induce a prompt change in strategy.

Second, bank boards must have both the information to allow and the incentives to promote swift remedial action. Information must be validated by independent audit committees. Directors should have their incentives aligned with the bank's long-term interests – by, say, being required to have, held by trustees and out of their control, a significant portion of their personal wealth in the bank's shares. They should also have an authority to act that comes from being independent from management and having appropriate knowledge and experience.

Basel II has imposed the maximum detailed regulation that the international banking system can bear. To enhance financial stability further, supervisors should focus on the structure of bank governance rather than on further intervention in the management of banks. Shareholders and boards should be made fully responsible for the conduct of the banking business. Bank supervisors should support them – not supplant them – in their supervisory duties. The forthcoming European Union capital directive that will implement Basel II could provide a valuable impetus towards this goal. The European Commission should not miss this chance to make the financial world a safer place.

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