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Bank Governance

The balance between official oversight and market discipline
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When I introduce the topic of bank governance, many interlocutors think I am referring to World Bank governance. Not that the latter is a light and uncontroversial subject! It rather reflects the fact that governance is usually associated with corporate governance. And that financial institution governance is not a headline topic. A report on governance in emerging markets issued last year by the International Institute of Finance, the worldwide umbrella organization of commercial banks, did not have a word about bank governance in emerging markets – or at very least about governance issues and constraints faced by their members. Yet, operating in riskier conditions should make bank governance a matter of legitimate consideration.

While not a current headline issue, bank governance is an important matter

It is true that, in the current cycle, financial vulnerabilities have not been magnified by spectacular bank governance failures, at least comparable in nature to those that have shaken the corporate world. Nevertheless, the reputation of some financial institutions has been tainted by their association with episodes of corporate distress – the Spitzer settlement and the JP Morgan-Enron surety bond dispute witness. And some issues at the core of current financial vulnerabilities may relate to the effectiveness of market-based discipline, of which internal governance is an essential pillar (such as, for instance, the stretched net worth position of leading insurers and the credit risk transfer position of other financial institutions).

My assertion is that bank governance matters a lot – and much more than is commonly acknowledged. I draw this assurance from personal experience as a board director representing the International Finance Corporation in several financial institutions in Africa as well as from exposure to policy considerations as part of my present World Bank work. The reality is that in any situation of financial distress, problems are either created or amplified by governance lapses.

The broad governance context

Before developing specific bank governance considerations, I would like to give you a sense of the broad picture I use as a reference when I think about governance – to move beyond the "plumbing" level to the level of principles. Corporate governance is the constitutional architecture of financial democracy – very much as the constitutional system is underpinning political democracy.

In the political world, citizens vest the legislative power (i.e., the expression of their willingness) in a parliament through elections. The parliament (or sometimes the citizens directly) votes in the executive branch, with the latter being accountable to the former for the execution of the citizens' goals. There is a third power, the judiciary, which controls the activity of the other two powers being independent from each of them.

In the corporate world, the investor (i.e. the citizen) votes for the appointment of the members of the board of directors which constitute themselves in the legislative function of the corporate activities. The board, in turn, appoints the CEO as the head of the executive branch who then appoints its management team, which is his cabinet. A whole spectrum of actors (investment bank analysts, credit rating agencies, bank credit officers, stock exchange authorities, securities

regulators, internal and external auditors and, in some extreme cases, the judiciary authorities) exercise, directly or indirectly, oversight over the activities of the corporation with effects that are broadly equivalent to those of the judiciary power in a democracy.

As much as political governance tends to align the executive power in the pursuit of the will of the citizens, corporate governance protects the individual investor against executive abuses. Corporate governance is really a system of institutions. What matters is both how each of them functions and how they interact with each other to achieve the stated goal. The focus of past attention has been the effectiveness of the executive power – witness the MBA studies, the management consulting industry, etc. The focus of present attention is the effectiveness of the legislative power and its interaction with the executive power. In the future, I predict that attention will shift to the effectiveness of the electoral process by which investors appoint and hold company boards accountable – very much as in the political arena. The role of institutional investors has been discussed in the *Myners* Report in the UK. And the debate has received a boost in the US with the recent SEC measures to have mutual funds disclose their proxy voting.

The current state of play in bank governance

Against this background, let me now zero in on the issue of the role of the legislative power in a financial institution context, that is on the role of the board.

I would like to state upfront that, in my opinion, current supervisory policies, guidelines and practices belittle the contribution of boards to financial stability. Let me qualify immediately this important statement. Supervisory policies do not belittle the importance of boards. For instance, a recent Basel Committee on Banking Supervision document states that "*The bank's board of directors has the ultimate responsibility for ensuring that senior management established and maintains an adequate and effective system of internal controls,...*"[1] . Bill McDonough, outgoing President and CEO of the New York Fed and Chairman of the Basel Committee on Bank Supervision, said: "*Financial stability can be achieved by the interaction of three basic necessities: sound leadership at the firm level, strong prudential regulation and supervision, and effective market discipline*". On leadership, he added: *"[It] begins with good corporate governance capable and experienced directors and management, a coherent strategy and business plan, and clear lines of responsibility and accountability*".

But, because policies organize the supervisory interaction with management and not with the board, they belittle the contribution of boards to financial stability. As a result, with management reporting de facto to supervisors, bank boards are crowded out from being the lynchpin of bank governance. A Basel January 2002 document reveals it: "*To enhance their understanding of a bank's corporate governance and system of operations, some supervisory authorities meet periodically with the bank's audit committee or its board of directors*"[2].

In banking, public policy could be construed paradoxically to hamper board oversight of management activities – just the opposite of its objective in the corporate sector. Financial stability considerations do not prejudice, in my opinion, a governance-enhancing supervisory action. Actually, strong bank boards can be essential elements of domestic financial market

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[1] Basel Committee on Banking Supervision, "*Internal audit in banks and the supervisor's relationship with auditors*", August 2001

[2] Basel Committee on Banking Supervision, "*The relationship between banking supervisors and banks' external auditors*", January 2002

stability, especially in environments marked by high risks and comparatively weak supervisory capacity, as is the case in many World Bank client countries.

The Basel Guidelines

Before trying to outline the implications of an underrated board role in developing countries, I would like to give you some references that illustrate how Basel supervisory guidance places boards and senior management at the same level – in contrast with the normal hierarchy of the latter reporting to the former. This makes it difficult for national bank supervisors, especially outside the G-10 club, to keep the board to a senior level of accountability vis-à-vis management.

In the "Enhancing Corporate Governance for Banking Organisations" September 1999 document, the Basel Committee on Banking Supervision states, as a matter of fundamental principle, that "*sound corporate governance can contribute to a collaborative working relationship between bank management and bank supervisors*", as if shareholder (and creditor) protection considerations were secondary. An illustrative quote of the lack of board centrality in bank governance is: "*Board of directors add strength to the corporate governance of a bank when they….*" Finally, to confirm the bank management governance focus, the document states "*senior management is a key component of corporate governance*". This framework is not bank supervision specific. It reflects the predominant management-centered governance model that has been pervading the corporate world up to very recently. Of course, current understanding of good corporate governance practice would make the board the single ultimate locus of accountability for company performance. Senior management would be accountable to the board for the execution of the business strategy. The Basel Core Principles 1999 document conveys the same board-management parity approach. For instance, Principle # 14 on risk management puts board and senior management at the same level in terms of accountability for risk management purposes to the bank supervisor. Principle # 22 on corrective measures does not refer to the board as the supervisor's prime interlocutor, even under a distress situation.

In the last couple of years, concerns about financial stability have come to the fore. Monetary stability, achieved at great cost, proved to be a necessary but not sufficient anchor for financial stability. This led to an increasing awareness that micro-prudential perspective has to be subsumed in a broader macro-prudential perspective if systemic financial crises are to be avoided. At the same time, the rapid growth of sophisticated financial intermediation paved the way for the discussion of the new Basel Capital Accord. It codifies an increased reliance on bank risk management and market discipline, consistent with the progressive embracing of system-wide considerations by supervisory authorities. Nevertheless, Basel 2 did not alter substantially the management-centered governance paradigma summarized above. Some detailed references could be useful.

The Basel guidelines for the Supervisory Review Process (the so-called Pillar 2) emphasize the importance of "*bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the bank's particular risk profile and control environment*". There is no reference to a board role. The document continues: "*Bank management is responsible for understanding the nature and level of risk being taken by the bank and how these risks relate to adequate capital levels."* I would submit this should be the board's responsibility first. Another indication of a "subdued" board role: "*A key function of senior management, in conjunction with the board of directors, is the design, implementation, and support of the bank's strategic plan*". The qualification "Under board oversight" would have conveyed a clearer message of a proper governance structure. And indeed the key statement "*the*

bank's board of directors has responsibility for setting the bank's tolerance for risks" is not given a particular prominence.

Similarly, the guidelines for Market Discipline (Pillar 3) seem to be geared for depositors and debt-holders – not shareholders. On market discipline, it is useful to recall Andrew Crockett's statement "*For market discipline to be effective, four pre-requisites have to be met: First, market participants need to have sufficient information to reach informed judgments. Second, they need to have the ability to process it correctly. Third, they need to have the right incentives. Finally, they need to have the right mechanisms to exercise discipline.*" Yet, Pillar 3 guidelines do not include considerations of how shareholders are exercising discipline on the board to take actions to mitigate risks. But the document states that "*There are a number of existing mechanisms by which supervisors may enforce requirements – through dialogue with the bank's management to reprimands to financial penalties.*" No mention of supervisory interaction with the bank's board.

In sum, what transpires from the guidelines is an implicit balance of roles and responsibilities between board and senior management that underplays the relative role of the former. An inadvertent consequence could be to let shareholders relax their supervisory duties. And when combined with the existence of deposit protection schemes, this may result in an unnecessarily reduced role played by market discipline. The overall implications for bank governance of this relative management centrality should be placed in the context of regulatory influence that lessens market disciplining forces in key aspects of bank competition (e.g., entry/exit, operations, management appointment, etc).

The developing country perspective

While this management-centered focus of bank supervisory doctrine may evolve in sophisticated markets to reflect good governance practices over time, it is not without consequences for developing countries today.

Let me start from the premise that financial sector deepening is the lifeline of sustainable economic growth. Financial deepening entails building more leverage in the economy – in all segments. That is, it means taking more risk. But inadequate risk management, precipitating in financial crises, can be very costly. The World Bank estimates the cost of financial crises in developing countries to have been of the order of $1 trillion in the last two decades – in addition to the post-crisis cost of lost output and employment. The regulatory response has to be market-friendly: it has to enable orderly growth – with an equal emphasis on both aspects. Hence harnessing the incentives of owners, as well as other market participants, is essential to fostering stability while minimizing any unintended repressive consequences of regulations. Bank governance is an essential underpinning for this process.

But there is another aspect of developing country banking that bears on risk management. It is the fact that foreign ownership plays an increasingly important role in financial intermediation. The bank FDI stock in developing countries has reached about $70 billion. Foreign banks have doubled their market share to 40% in 61 of the poorest countries. And bank FDI flows continue to be buoyant. It takes primarily the form of equity stakes or establishment of subsidiaries. Compared to foreign branches, these are organizations with several structural arms-length elements from head office, including a dedicated board. Their corporate governance arrangements matter.

Despite great progress made in coordinating cross-border supervision procedures between home and host country authorities, supervisory practices are also informed by pragmatic considerations.

A former central bank governor in a central European country said that "A*t the end of the day, the responsibility lies with the strategic investor*". But this view is not always shared by the home country supervisor who might not have the analytical and enforcement instruments to fulfill its responsibility in respect of foreign affiliates. The collapse of two foreign-owned banks, in the Czech Republic and in Croatia, brings home this risk.

Lack of formal regulatory guidance and imperfect cross-border supervisory arrangements create a significant governance fault line at the most vulnerable point – the board itself. In this regard, I would like to note the bad example set by the recently issued US Conference Board corporate governance guidelines. They state that the requirement to have a strong majority of independent directors is waived in majority-owned affiliates, even if located abroad! A strategic investor faces several hurdles in wrapping seamlessly foreign operations under its head office risk management platform. Even with a majority stake, it can be de facto an outsider - problems of local management loyalty or entrenchment.

Current bank governance arrangements could be strengthened

Connected lending, excessive loan concentration, single exposure limit breached, overestimation of guarantees (including government) are common pitfalls for all banks. But credit risk is only one of the areas that could affect bank liquidity and solvency. Another key risk area is treasury-related. Nobody would dispute the assertion that a strong and independent bank board could play an essential role in monitoring these practices (especially in government- and locally-owned banks).

Foreign-owned banks are deemed to be relatively sheltered from poor management because of proven head office management systems. I do not want to disprove this assessment. But it cannot be taken without qualifications. In summer 2002, prompted by significant losses in their corporate bank in Argentina, Citibank decided to absorb its emerging market division into its bigger international group. Its CEO, Mr. Weill, explained it as follows: "*To have a more pro-active, ongoing, all-the-time, looking-forward approach to the changing risk situation. It [having a separate emerging markets division] separated it too much from the rest of the company*".

In the case of foreign-owned affiliates, I believe that head office governance structures are not fully adequate to capture the specific risks overseas. Hence the need to decentralize governance closer to where the risks are. In this respect, the usual governance arrangements, where head office line executives run the affiliate board, do not provide adequate assurances of a strong and independent board. It also makes it more difficult for the head office board to make a comprehensive assessment of "consolidated" governance issues.

When the board is dominated by executives that are responsible for the operating performance of the affiliate, the board loses its statutory ability to provide independent oversight. This situation is often worsened when head office provides technical assistance to the affiliate. In this case, its head office executives represented on the local board should be considered, for all intents and purposes, management. In this instance, boards are equivalent to those of owner-operated banks – the riskiest bank segment according to research. And if you have a situation of entrenched management, perhaps protected by a shallow local labor market, you can easily see a problem of "board capture", if not one of "majority shareholder capture", looming.

Société Générale in Central Europe is a rare example of good practice: it has appointed a number of senior head office non line executives (e.g., head of domestic retail, head of credit, legal counsel) as well as a number of independent French business people to its foreign affiliates

boards. Other banks lag behind: in one instance, the foreign board is chaired by the head of the regional division with the majority of its members reporting to him in head office. I doubt that many dissenting voices will be raised to question the effectiveness of the management assistance program and the overall performance of the affiliate. The consequence may be that the local CEO may operate substantially unfettered, especially if he has a local power base.

Enough of analysis and diagnostic. It is time to move to conclusions and some suggestions.

The imperative to create conditions that are conducive to rapid and sustainable financial intermediation growth places supervisory authorities of developing countries in the position to look for additional sources of market-based discipline. Alan Greenspan said "*Supervisors have little choice but to try to rely more –not less—on market discipline*". Andrew Crockett echoed "*Regulation should try to respond to the realities of the market, rather the other way round*". With market discipline stunted on the debt side by the widespread application of deposit insurance schemes, shareholder-driven discipline acquires a particular importance. The recent emphasis on board role and effectiveness, originated in the corporate world, is making shareholders and directors ready to play an enhanced role. We should take inspiration and draw comfort from the vision of the board role projected by the Higgs Report which says: "*The Board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed.*"

Role of bank boards can be enhanced

Financial stability and supervisory authorities can leverage this trend and be more prescriptive and more ambitious about the specific responsibilities of boards. They should leave no doubt that they consider the boards to be their direct interlocutors and allies in preserving financial stability – not senior management. They should state unequivocally, and enforce it in practice, that senior management is accountable to the board, with the latter being accountable to supervisors, while keeping open all existing lines of communication with management.

In terms of supervisory practices, national authorities could start enforcing the good corporate governance practices that are now emerging in the corporate world, even before the Basel community issues updated guidelines. For instance, they could ensure that, over time, most board members fulfill in substance the requirement of being non-executive and that a sufficient number amongst them be also independent. This is the route on which the Hong Kong Monetary Authority has embarked in the wake of the Asia crisis. Nomination criteria and procedures should be clearly spelled out and uncompromisingly enforced – beyond the "fit and proper" test. Boards play too critical a role to be filled by persons that do not meet the professional skill test applied for bank management and other senior professional advisors.

And, more importantly, specific supervisory processes should be developed to assess the effectiveness of board oversight as the first bulwark against financial instability. Given the complexity of bank business, supervisors need to assess the adequacy and effectiveness of board sub-committees that are responsible for different facets of risk management (perhaps mirroring the Pillar 2 components – capital adequacy, credit risk, market risk and operational risk). To underline board accountability, supervisory authorities may wish to establish a set of remedial actions in respect of lapses in board performance. They should communicate their summary assessment of the effectiveness of bank's governance arrangements to shareholders meetings so as to help reinforce the corporate checks and balance system.

As supervisors gain experience of the full potential of board oversight, one could envisage an eventual delineation of an indicative division of labor between board oversight and supervisory focus – perhaps with elements of lead, joint and secondary responsibility or emphasis.

Experiments in raising the performance bar for bank boards in the national context may prove very useful in informing discussions at the international level, and perhaps also in Basel. The Global Corporate Governance Forum and the World Bank can assist in collecting information on these efforts and making it available worldwide (leveraging on the existing FSAP process).

Conclusion

Given the need to stimulate economic growth in developing countries and the large role that financial sector deepening can play in this respect, it would be silly to disregard the energy and discipline that boards and, through them, shareholders can provide. With the political architecture in mind, one cannot dispense of a strong legislative to effectively execute the citizens' will. In banking, "citizens" are shareholders, depositors and borrowers. They have a vested interest in a solid financial system. They should be prodded to take more responsibility. Why focus discipline and benefits of public action on management behavior only?

Bank supervisors should multiply their point of entry in the financial system. After having outlined the principles of a collaboration among supervisors, external and internal auditors, their next step could be to design the principles of an engagement with boards and shareholders. As articulated for instance in the January 2003 *Smith* Report on Audit Committees Combined Code Guidance in the UK, an empowered board through its audit committee acts as the essential catalyst for the effective involvement of other key governance actors such as the internal and external auditors and, beyond them, credit and rating agencies analysts. Of course, bank boards and shareholders will only be able to step up their governance contribution over time. But this will not happen without initial public intervention.

In spreading the scope of their activity, supervisory authorities will strengthen each of the three institutions underpinning financial democracy – and give market discipline a boost. Financial stability will benefit.