Caribbean Corporate Governance Forum

# The Role of Banks in Corporate Governance

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# Definition

"Corporate governance are the set of arrangements that maximize the incentives for value-enhancing investments while minimizing inefficient power seeking."

-Prof. L.Zingales

→ It is the issue of how to get managers to work for shareholders and majority shareholders to work for all shareholders

# The Main Function of Banks

- To mobilize savings into productive investments
  - To screen creditworthy borrowers and projects
    - Appropriate lending policy
  - To monitor use of borrowed funds as intended
    - Appropriate credit administration
      - Supported by sound corporate governance
  - To ensure recovery of loaned amounts
    - Enforcing creditors' rights
    - Through possible restructuring of loan terms

→ A critical role in upholding incentives for value-enhancing investments

# The Role of Banks in Corporate Governance

## Considerations

- Most influential role among contractual corporate suppliers
- Their negligence could lead to serious governance lapses
  - Role of banks in recent corporate collapses
- Large role in special situations
  - Corporate restructuring situations
  - Short-term maturities
  - Weak creditors' rights context
- Large role also when high financial leverage
  - Germany and Japan examples
  - But is it conducive to maximizing value-enhancing investments?

Key Issue: Does strong creditor influence help (small) shareholders?

# The Role of Banks in Corporate Governance (2)

## Potential Shortfalls

- A diversified financial system offers a more resilient credit intermediation service to the economy
- Strong bank relationships do not foster transparency and disclosure
- High leverage made possible by bank loans may stifle other funding sources with complementary management disciplining effects
- Special issues related to ownership of banks
  - Conglomerates (connected lending)
  - Government
- …and to their official supervision arrangements
  - Any unintended indirect influence on corporate governance?

# *Quis Custodiet Ipsos Custodes*?[1/]

- Corporate governance of banks is an essential element of a country's governance architecture
  - It can have systemic financial stability implications
  - It can shape the pattern of credit distribution and overall supply of financial services
  - It can set the tone for corporate governance in the non-financial sector

1/ "Who is to guard the guards themselves?" -Juvenal, Satires

# Bank Governance

## Main Issues

- Authorities play a direct role in bank governance through bank regulation and supervision
  - Unlike in the corporate world
  - Justified by financial stability and deposit insurance liability considerations
  - Acting almost as a “parallel” owner
- Shareholders enjoy the benefit of high leverage with the downside protection of deposit insurance
  - Weakened incentives for strong management monitoring

→ Key Issue: Who controls management? Boards or bank supervisors?

# Bank Governance

## Current Trends

- Stronger emphasis on risk measurement and management by Basel II
  - Helps monitor management actions
- Emerging role of “market discipline” as a complement to bank supervision
  - Sanctioned by Basel II (Pillar 3)
  - Particularly by uninsured bank creditors
- But still room to enhance shareholder discipline
  - Essential to further financial stability without stifling financial innovation

# Bank Governance

## Some Suggestions

- Supervisors should help board and shareholders exercise discipline – and not supplant them
  - Shareholders are essential pillars of market discipline
  - Their incentives must be made to align with those of authorities
- Supervisors must make boards main locus of accountability
  - While keeping open communication channels with management
  - Management to be made accountable to board, not to supervisors
- Supervisors should assess board effectiveness
  - Particularly sub-committee work
    - Audit committee critical for accuracy of information
  - Role of independent and non-executive directors
    - Special situations of foreign-owned banks

# The Role of Banks in Corporate Governance

## Conclusions

- Banks are important stakeholders of corporations
  - Their actions can affect corporate performance
    - Both positively and negatively
  - But their influence as lenders should complement effective shareholder monitoring and protection of minority rights
- Governance of banks is an essential element of a country’s governance architecture
  - Enhanced role for shareholders and boards, helped by bank supervisors