High-Level Working Meeting on the
OECD Principles of Corporate Governance

The Role of Banks In Corporate Governance

Discussion Notes

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A Useful Definition

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

-Prof. Luigi Zingales

Lenders Can Uphold Good Corporate Governance

- Important “checks-and-balance” role vis-à-vis management
  - To screen creditworthy projects
  - To monitor use of borrowed funds as intended
  - To ensure recovery of loaned amounts as contracted
  - To dictate value-creating restructuring terms if necessary
- “Minimizing inefficiencies”
  - Per the Zingales definition
- Also, “adding value”
  - A quasi-equity partner at times of distress

…Helped By Enforcement of Creditors’ Rights

…But This Is Not A Panacea…

- Banks may crowd out other disciplining creditors
  - Excessive leverage and short-term maturities
- Banks do not promote transparency and disclosure
  - Their close relationship overcomes informational barriers
- Banks are cautious about funding innovation
  - Entrepreneurs may drop value-maximizing investments
- Banks may keep undeserving companies alive
  - Delaying redeployment of scarce capital

Bank-Based vs. Market-Based Finance

- This is an old and inconclusive debate
  - Germany/Japan vs. UK/USA
- Diversified financial systems are better at promoting sustainable economic growth
  - Need for both banks <u>and</u> markets
- Legal rights of both creditors and shareholders matter!
  - Lender and shareholder interests not always aligned
    - Need to protect shareholder "residual" control rights

Bank discipline valuable but
should not drive financial sector development strategy.

Governance of Banks Matters, Too

- Banks do contribute to good corporate governance
- Who determines how well banks are run?
- Response:
  - Unlike in other sectors, public authorities have a large influence in banking governance
    - Regulation and supervision
- Does this matter?
  - YES!

Main Bank Governance Issues (1)

- Supervisors lead oversight of management activities
  - Because of potential for systemic implications of banking instability
  - But acting as a “parallel” owner
    - On behalf of taxpayers (deposit insurance)
- Does this have any impact on shareholder monitoring?
  - How does board oversight relate to supervisory oversight?

Main Bank Governance Issues (2)

- Bank shareholders are perceived to provide unreliable discipline
  - They are much more leveraged in banking than in other industries
    - Largest share of profits made with third parties' funds
  - Bank shareholder seen as a "gambler"
    - Taking the upside and leaving the downside to others (e.g., deposit insurance)
      - Not banking-specific moral hazard
      - In banking, the taxpayer pays, not the other creditors
        - » Is deposit insurance fairly priced?
    - True risk: when "downside" larger than value of bank franchise
      - When capital has already been depleted
        - » But this is rarely an instantaneous process…

Bank Governance: Little Room For Shareholder Discipline

- Shareholder monitoring incentives disregarded
  - Normal incentive to protect and enhance value of bank franchise
  - Under distress: share prices are better lead indicator than bond prices!
- Boards by-passed as principal locus of accountability for bank stability
  - Result: more intrusive bank supervision
- But supervisors have recognized need for alliances to monitor bank stability
  - A good start: Basel II Pillars 2 and 3
    - But focused on creditors and uninsured counter-parties

A Nagging Question

Who is the real risk-taker in banking?

- Management?
- Shareholders?
- Taxpayers?

Usually, issue is how to control corporate insiders

- Why would banking be any different?
- And banking is more complex and opaque than other industries…

More Bank Shareholder Discipline

- Financial crises cost $1 trillion in developing countries
  - Crowding out better use of scarce fiscal resources
- Growth will require further financial deepening
  - It means putting more risk assets in the banks
- Bank supervisory capacity may not grow fast enough to match ever more complex market practices
  - ➢ Shareholders should be made responsible for their investments, through adequate and responsible monitoring
    - ➢ Incentives for risk-controlled strategies (to avoid moral hazard)

Shareholders should set the tone of bank influence on sound corporate governance practices– not bank supervisors!

Bank Boards Need A Revamp

- Boards are the main transmission mechanism of market signals to risk management actions
  - From market “monitoring” to market “influencing”
- Boards can best influence management to adopt an appropriate risk/return strategy
  - Best placed to launch prompt and gradual remedial actions
    - Before bank franchise value starts being depleted
- Boards can best incorporate supervisory concerns in their on-going on-site oversight
  - Supervisory input will enrich their risk assessment
  - They will feed it back to shareholders

…And Supervisors Will Be More Effective!