Corporate Governance in the Banking Sector

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Abstract
Corporate governance has at its backbone a set of transparent relationships between an institution's management, its board, shareholders and other stakeholders. In this article, in the first part, the nature and purpose of corporate governance has been discussed with special emphasis on the problems of banks in the field of corporate governance. Also, the conflicts in case of Indian scenario have also been described. In the second part, the report by the Basel Committee has been explained and also how is helps in the corporate governance in banks. And, in the third part, the best practices regarding corporate governance in banks have been illustrated. Finally, the project concludes by saying that banks, being a separate category of financial institutions require specialized set of norms for corporate governance.

Keywords
Corporate Governance, Banking Sector, Banks, Best Practices

I. Introduction

Corporate governance has at its backbone a set of transparent relationships between an institution's management, its board, shareholders and other stakeholders. It, therefore, needs to take into account a number of aspects such as, enhancement of shareholder value, protection of shareholder rights, composition and role of board of directors, integrity of accounting practices and disclosure norms and internal control system. In a service industry like banking, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their board of directors and senior management. It also provides the structure through which the objectives of the institutions are set, the strategy for attaining them is determined and the performance of the institution is monitored.

Virtually every major industrialized country as well as the Organization for Economic Co-operation and Development and the World Bank has made efforts in recent years to refine their views on how large industrial corporations should be organized and governed. Academics in both law and economics have also been intensely focused on corporate governance. Oddly enough, in spite the general focus on this topic, very little attention has been given to the corporate governance of banks.

In this article, in the first part, the nature and purpose of corporate governance has been discussed with special emphasis on the problems of banks in the field of corporate governance. The conflicts in case of Indian scenario have also been described. In the second part, the report by the Basel Committee has been explained and also how it helps in the corporate governance in banks. And, in the third part, the best practices regarding corporate governance in banks have been illustrated. Finally, the project concludes by saying that banks, being a separate category of financial institutions require specialized set of norms for corporate governance.

II. Nature and Purpose of Corporate Governance

A. The Corporation as a Contract

Corporation should be viewed as nothing more than a set of contractual arrangements among the various claimants to the products and earnings generated by the business. The group of claimants includes not only shareholders, but also creditors, employee-managers, the local communities in which the firm operates suppliers and of course, customers. In the case of banks, these claimants also include the regulators in their role as insurers of deposits and lenders of last resort and in their capacity as agents of other claimants [1].

B. The Economic Nature and Purpose of Fiduciary Duties

To the extent fiduciary duties lower the agency costs by reducing the freedom of management to act in its own unconstrained self-interest, such duties will be especially valuable devices in banking context because of inherent difficulties in monitoring banks [2]. Not only are the bank balance sheets notoriously opaque, but as Furfine [3] points out, "rapid developments in technology and increased financial sophistication have challenged the ability of traditional regulation and supervision to foster a safe and sound banking system."

The duty of care requires that directors exercise reasonable care, prudence and diligence in the management of corporation. Director liability for a breach of the duty may arise in two discrete contexts. First, liability may flow from "ill advised or negligent" decision making. Second, liability may be as a result of the failure of the board to monitor in "circumstances in which due attention would, arguably, have prevented the loss" [4].

C. To Whom Should Fiduciary Duties be Owed?

The standard law and economics view regarding fiduciary duties is that corporations and their directors owe fiduciary duties to shareholders and shareholders alone. There has been much debate over the issue of whether shareholders should be the exclusive beneficiaries of directors' fiduciary duties [5].

D. Separation of Ownership and Control

The problem of corporate governance is rooted in the Berle-Means paradigm of the separation of shareholders' ownership and management's control in the modern corporation. Agency problems occur when principal lacks the necessary power or information to monitor and control the agent and when the compensation of the principle and agent is not aligned. Several factors work to reduce these principal agency costs.[6]

Banks are organized in a variety of ways, from stand alone corporate entities and single bank holding companies to multiple bank holding companies and the post-Gramm-Leach-Bliley Act diversified banking holding company.[7] To the extent that some of the largest US banks, like Citibank and Bank of America, are wholly owned subsidiaries of holding companies, these banks will not resemble the prototypical US corporation in which ownership is divorced from control along the lines described by Berle and Means [8].

III. Special Problems of Banks

The question that needs to be answered here, is how important is the issue of corporate governance in banks and other financial institutions. Banks, just like any other organization are incorporated entities. As a result of which, the primary requirements of corporate governance apply to them as any

other incorporated entity. Added to this certain features that are very specific to banks, adds on to the importance of Corporate Governance issues in banks.

A. Banks as an Integral Part of Country's Economy

Among other features, the most important one is the fact that banks form an integral part of the economy of the country, and any failure in a bank might have a direct bearing on the financial health of the country. Banks, help in channelizing the people's saving [9].

B. The Liquidity Production Role of Banks

The capital structure of bank is unique in two ways. First, banks tend to have very little equity relative to other firms. Second, banks' liabilities are largely in the form of deposits, which are available to creditors/depositors on demand, while their assets often take the form of loans that have longer maturities. Thus, the principle attribute that makes banks as financial intermediaries "special" is their liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy [10].

The liquidity production function may cause a collective-action problem among depositors because banks keep only a fraction of deposits on reserve at any one time.[11] Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run.[12]

C. Funding Pattern of Banks

The second important driver of a good corporate governance stems from their funding patterns. Banks, by their basic definition are highly leveraged financial institutions, with the equity capital of the shareholders being reduced to a miniscule proportion of loan capital in the form of borrowing and deposits of deposits from customers of the bank. As a result of this, the stakeholders in banks, (mainly the depositors and lenders) have a rightful claim of accountability from the banks and their boards [13].

D. Control function

The third important element in the Corporate Governance structure relates to the control function. It is imperative to discuss the same in brief. Control functions in banks deal with internal frauds as well as external frauds [14].

The former relates to situations where the banks own personnel indulge in corrupt and unethical practices. The latter deals with situations where the customers of the bank try to seek for malpractice. The incidents of the external frauds are so devastating that special attention is being mandated both for their prevention as well as their post scenario analysis. In this connection it is important to remind of the COSO framework that was framed with this intention in mind [15].

E. Failure to Comply With Stipulated Norms

Finally, failing to comply with stipulated norms can be one of the challenging issues of Corporate Governance framework. With Banks being under intense watch of the central bank as well as other regulatory bodies, it is a common observation, that most failures (crashes) in banks have occurred due to compliance failure situations.[16] With a lot of reports and norms, being introduced (The Basel II norms being the latest of them), failure to adhere to the regulatory norms have never reduced. At this juncture, it becomes essential to discuss as to what roles the Governments have relating Governance issues in banks and what is the necessity of Government intervention in banks [17].

F. Asset Structure and Loyalty Problems

The presence of a federal insurance fund also increases the risk of fraud and self-dealing in the banking industry by reducing incentives for monitoring. In the 1980s, it was estimated that fraud and self-dealing transactions were "apparent" in as many as one-third of today's bank failures.[18] A similar statistic shows that between 1990 and 1991, insider lending contributed to 175 of 286 bank failures.[19] Such behavior, is of course, a possibility in any large firm, since it is inefficient for the owners to monitor all employees at all same times. These sorts of problems are particularly acute in financial institutions, however, because of the large portion of their assets held in highly liquid form [20].

IV. Corporate Governance in the Indian Banks and the Embedded Conflicts

About four-fifths of the banking business in India is under the control of public sector banks. This phenomenon complicates the corporate governance since the effective management vests with the government, while top management and board of banks operate merely as functionaries.[21] It is time that the nation debates whether corporate governance is compatible with the present form of public ownership as it makes the head of the institution accountable to political institutions.[22] In view of this dichotomy, even dilution of government holdings to below 51% cannot guarantee good corporate governance practices, unless the government defines its very role de novo. The Joint Parliamentary Committee on Stock Market Scam observes that it is imperative for banks to follow strategies and techniques basic to all tenets of corporate governance.[23]

V. Bank Corporate Governance : What Standard to Apply?

The duty of care has a long and controversial history in banking. The first case to articulate the modern "tort-based duty of care for bank directors" was Briggs v Spaulding [24]. In Briggs, the president of the First National Bank of Buffalo caused the bank to become insolvent by making illegal and unsound loans to himself, members of his family, and third parties with little or no financial credibility. The bank's directors "gave no attention whatever to the management of the bank's business," but instead relied on the president to conduct and manage the affairs of the bank. The bank's receiver ultimately sued several of the bank's officers and directors, alleging that the bank had suffered losses as a result of "the misconduct of the officers and directors" and their failure "to perform faithfully and diligently the duties of their office." In determining the standard of care required of banking directors, the court held that, "directors must exercise ordinary care and prudence in the administration of the affairs of a bank," which requires "something more than officiating as figure-heads." Thus, by requiring that directors of depository institutions exercise "ordinary care" in conducting the affairs of a bank, Briggs established "a federal common law standard of simple negligence for directors of federally chartered and federally insured depository institutions."

In setting this standard of care, however, the Briggs Court recognized that there are costs to setting fiduciary standards too high: "One must be very careful . . . not to press so hard on honest directors as to make them liable for these constructive

 ISSN : 2330-9519 (Online) | ISSN : 2231-2463 (Print)

defaults, the only effect of which would be to deter all men of any property, and perhaps all men who have any character to lose, from becoming directors of companies at all"[25].

VI. Basel II : Ensuring High Standards of Corporate Governance

The Basel Committee on Banking Supervision is a committee, of banking supervisory authorities, established by the Central Bank Governors of the G10 developed countries in 1975. The Committee in 1988 introduced the Concept of Capital Adequacy framework, known as Basel Capital Accord, with a minimum capital adequacy of 8 percent.[26] It also issued a consultative document titled "The New Basel Capital Accord" in April 2003, to replace the 1988 Accord, which re-enforces the need for capital adequacy requirements under the current conventions. This accord is commonly known as Basel II and is currently under finalization. Basel II is based on three pillars:

- Pillar 1 – Minimum Capital Requirements
- Pillar 2 – Supervisory Review Process
- Pillar 3 – Market Discipline

A. Enhancing Corporate Governance In Banks

The Basel committee had issued, in August 1999, a guidance paper entitled "Enhancing Corporate Governance for Banking Organizations" to supervisory authorities worldwide to assist them in promoting the adoption of sound corporate governance practices by banks in their countries [27].

B. Importance of Corporate Governance for Banks

From a banking industry perspective, corporate governance involves the manner in which their boards of directors and senior management govern the business and affairs of individual banks, affecting how banks set their corporate objectives, run day-to-day operations, consider the interests of various stakeholders, align corporate activities with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations and protect the interests of depositors [28].

C. Sound Corporate Governance Practices for Banks

According to the paper some of the best corporate governance practices for banks include establishing strategic objectives and a set of corporate values communicated throughout the organization, strong risk management functions, special monitoring of risk exposures, setting and enforcing clear lines of responsibility, etc [29].

VII. Role of the Central Bank in Promoting Corporate Governance

The growing competitiveness and interdependence between banks and financial institutions in local and foreign markets have increased the importance of corporate governance and its application in the banking sector. Corporate governance in banks can be achieved through a set legal, accounting, financial and economic rules and regulations. To make sure that the competence and integrity in banking sector is maintained, the need for uniform standards of the concept of governance in private and public sector is emphasized. The regulatory framework implemented by the central bank can affect the overall well being of banking sector [30].

VIII. Best Practices of Corporate Governance in Banks

Good governance can be built based on the business practices adopted by the board of directors and management. Many bank failures in the past have been attributed to inadequate and insufficient management which enabled the banks to accept low quality assets and assume additional risks that extend beyond the level appropriate for the banks' capacity [31]. Important commandments for ensuring corporate governance in banks are:

A. Banks shall realize that the times are changing

The issue of corporate governance has gained attention only in the recent times. Therefore, even the smallest banks need to focus on corporate governance restructuring. This is due to the apparent lack of integrity and values in operation of some large corporations [32].

B. Banks shall establish an Effective, Capable and Reliable Board of Directors

Establishing an effective, capable and reliable board of directors requires involving well qualified and successful individuals with integrity. This implies that a majority of banks' board of directors should be truly independent directors. The board must be effective and must meet periodically and it should also have long-term policy, strategy and values [33].

C. Banks shall establish a Corporate Code of Ethics for themselves

Corporate ethics and values should be established at the top and should be used to govern the operations of the bank both from long-term and short-term point of view. These codes should be reviewed annually. Unless this exercise is accomplished, executive management cannot anticipate that the rank and file employees will follow such a code on their own [34].

D. Banks shall consider establishing an office of the Chairman of the Board

Such an office will be made to report to the board and will act as the board's eyes and ears on a daily basis in connection with the functions of the bank [35].

E. Banks shall have an effective and Operating Audit Committee, Compensation Committee and Nominating/ Corporate Governance Committee

The audit committee, compensation committee and nominating committee should be composed of all independent, outside directors of the bank who operate independently. These committees should have access to attorneys and consultants paid for by the bank. This independence of committee will ensure against any bias in the internal audit committee's decisions [36].

F. Banks shall consider Effective Board Compensation

Fair compensation should be paid to the directors. Their remuneration should be commensurate to with the risks they take [37].

G. Banks shall disclose the information

Bank will find that the disclosure will be quicker and more burdensome than it was in the past. This may be through quarterly letters to the shareholders or other types of communication [38].

H. Banks shall recognize that duty is to establish Corporate Governance Procedures that will serve to enhance shareholder value

The primary objective of the board of directors is to maximize

the shareholders' wealth. The strategy adopted to achieve this objective should now encompass corporate governance procedures and should be designed with long-term value for shareholders in focus [39].

IX. Conclusion

The special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in developing economies such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank capital and the presence of distributional cartels.

Due to special nature of the activities carried on by the banks, they face a lot of problems as far as the area of corporate governance is concerned. Also, in the Indian scenario, due to the peculiar nature of bank holdings there are a lot of embedded conflicts. There exists a doubt as to what standard should be applied while enforcing corporate governance in banks. Central banks play an important role in this regard. The guidance paper issued by the Basel Committee is of paramount significance in enforcing corporate governance standards in various countries across the world.

As far as best corporate governance practices for banks are concerned, they may include realization that the times are changing, establishing an effective, capable and reliable board of directors, establishing a corporate code of ethics by the banks for themselves, considering establishing an office of the chairman of the board, having an effective and operating audit committee, compensation committee and nominating/ corporate governance committee in place, considering effective board compensation, disclosing the information and recognizing their duty to establish corporate governance procedures that will serve to enhance shareholder value.

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