GOVERNANCE ISSUES IN BANKS: COULD REGULATORS SOLVE THE PROBLEMS?

W.A. Wijewardena

Governance issues in banks have come to the forefront of discussion in the recent past, especially after several banks failed globally and some banks underwent difficulties locally. Inquiries into the causes of failure of or difficulties in the banks in question revealed that there had been serious lapses in the governance structures in those banks that had led to mismanagement, abuse of power and resources and irregularities in lending and handling depositors' money. As a quick solution, many banking regulators resorted to either tightening the already prevailing good governance regulations or introducing new regulations on same. The Bank for International Settlement (BIS), on its part, together with other major central banks in the world, initiated action to introduce a new set of good governance guidelines through its Basel II Committee as a matter of urgency. Accordingly, as of today, almost all the countries in the world have brought into their regulatory structure good governance guidance for banks making the good governance principles a uniform standard for the entire globe. Hence, based on these recent global developments, one may be led to surmise that, as far as banking issues relating to governance factors are concerned, the problem has now been permanently fixed by banking regulators.

This paper will discuss the importance of addressing governance issues in banks, the salient features of the guidelines issued in the recent past and the shortcomings of the governance structure that has been put in place through regulatory means.

Why Good Governance Practices are Needed?

Banks, like other economic entities, ensure their sustenance by producing an output and selling that output in the market. Hence, it is the customer pressure that should compel banks to follow good behavioural practices and safeguard the interests of people who have trusted them and made available their savings by way of deposits for conducting their businesses. In a soap producing company, this happens naturally in the market. If the output of the soap producing company is not acceptable to the customers, they would move from that particular brand to another brand. The loss in demand and the consequential loss in profits will eventually compel the soap manufacturer to go out of business. So, being fearful of the customers' wrath, the soap manufacturer has all the incentives to produce his output as demanded by them and thereby safeguard their interests. The good behaviour of the soap manufacturer is therefore ensured by the market pressure.

In the case of banks, this does not normally happen because banks are not allowed to fail by the authorities. There is a valid reason for this protective measure too. Unlike a soap manufacturer, the failure of one bank may trigger a series of bank failures, because banks are linked to each other through inter-bank financial obligations. A country cannot afford to witness such a general collapse of the entire financial system, because, in modern economies, all economic activities depend on the health of their financial systems. Hence, a country cannot allow a general financial failure unless it is willing to experience a general economic failure too. Because of this systemic importance of banks, countries normally do not allow banks to close their businesses, even though that may be the better course of action that could have been followed. This was the experience which the world had in the recent episode of banking and financial failures in both developed and developing countries.

However, this general protective attitude of authorities towards banks has made them less concerned about the need for following good behavioural practices. The situation is equivalent to a child developing a less serious attitude towards studies when he knows that at the end somehow examiners would not allow him to fail in the examinations. Similarly, banks too would use the protective cover extended by authorities as a licence to take unnecessary risks, lower or disregard the internal norms for safe behaviour and get into unethical practices. This behaviour, known as 'moral hazard behaviour', is injurious to the good health of a bank and thereby raises the probability of bank failures passing an unexpected burden on bank regulators.

The break-down of good governance principles in banks may occur due to another reason. That is 'the principal-agent problem' in which the motives and objectives of the agents diverge from those of the principal who has engaged them to accomplish a given set of tasks. This break-down may occur at different levels of principals and agents in the case of a bank: between the shareholders and the board; between the board and the management and finally between the creditors and management/board.

Shareholders as the principal have appointed the board to run the bank efficiently, effectively and profitably so that, through efficient operations, the shareholders' value will be enhanced. But, unfortunately for shareholders, their interaction with the board is very limited and often confined to the general meetings which a bank may have once a year. In addition, when the shareholder base has been expanded to broad base the ownership, most of the shareholders would resign themselves to the status of 'sleeping shareholders' totally unconcerned about the happenings in the bank. This general apathy of the shareholders will give an opportunity to the board to seek after their personal objectives and goals. In such a situation, it is quite natural for a board to deviate from the expected good behavioural practices.

Between the board and the management, a similar break-down of the governance practices may occur due to the same divergence of objectives of the two parties and the boards' inability to exercise an effective control over the management. This happens when the boards become 'lame duck boards' with no interest in the affairs of the bank either due to a lack of knowledge or due to a lack of time for devotion to the work of the bank. When the board members suffer from either of these weaknesses, they would invariably become hostages of the management and would not make a contribution other than being a mere rubber stamp for everything which the management does or propose. It gives a free hand to the management to run the affairs of the bank and also an incentive to deviate from the good behavioural practices expected of them.

Between the creditors and the board/management of a bank, the passive nature of both depositors and creditors will allow the board and the management to disregard the good behavioural practices which they would have otherwise followed. Banks are vulnerable to this ailment more than any other organisation because the deposit base of banks normally consists of a large number of small deposits and the owners of these deposits cannot exercise any effective control or surveillance over the board and the management either individually or collectively. They cannot do it individually because they lack bargaining power or voice; they cannot do it collectively because it involves a high transaction cost. The end result of the passivity of depositors and creditors in exercising vigilance or surveillance of a bank's affairs is the incentive given to both the board and management to run the bank without regard for the obligation they have toward their depositors and creditors.

It is apparent from the above that the principal-agent problem and the inability of the principal to exercise an effective control over the agent would lead to a general break-down of the governance principles in a bank. It is surprising that a board which on one occasion functions as a principal upholding good governance practices chooses to deviate from same when it functions as an agent. The main reason for this dualistic behaviour is the appointment of board members who are not 'fit and proper' to hold positions and the over-reliance of board members on the chairman and the management for the good running of a bank. Hence, either due to a total lack of knowledge of what is actually happening in a bank (innocent over-reliance) or due to collusive behaviour (unfit and improper to hold position because the members are not genuine), a board may play a 'double role' when it comes to pursuing governance principles.

Since the odds are greater in a bank for a general break-down of good governance practices, many regulators have felt it necessary to introduce them as a mandatory requirement. If such regulations are to be successful, they should provide an ethical and moral framework for a bank's board and the management to seek after the individual goals without compromising the goals of the bank and the interests of the depositors, shareholders and the creditors. It requires on the part of each member of the board and the management to work according to conscience so that, under no circumstance, they would be compelled to resort to any unethical or immoral practice. It also makes it necessary for each member of the board and the management to cultivate some cherished personal qualities: self discipline, self restraint, self control and self realisation.

The Regulated Governance Principles

In the midst of the failure of banks to have a self-regulated system of good governance in place, banking authorities have attempted to fill the vacuum by introducing a regulated system of governance for them. The examination of these regulated governance principles has shown that they all have followed a similar pattern pointing to a single source-drawing. According to the Basel Committee guidance Paper on Corporate Governance in Banks, the establishment of a proper governance culture is the responsibility of many: boards of directors, senior management; banking regulators and other stakeholders. The last category includes different types of individuals and associations such as depositors, creditors, shareholders, employees, auditors, trade and banking associations, other regulatory bodies such as securities and exchange commissions, rating agencies and governments which stand to gain if banks get into a proper governance culture.

The Basel Guidance Paper has qualified its contents as principles and not as rules. Accordingly, the application of these principles will vary from bank to bank depending on the size, risk profile and the nature of the market it operates. However, when they were translated into practice, all the banking authorities have issued them as regulations which have to be compulsorily followed by banks without exception. Hence, all banks, whether they are big or small or risky or non-risky, have to adopt the same regulatory rules relating to governance.

The three principal parties which are involved in good governance practices in banks have to play three different roles relating to the same. In this context, the board of directors should exercise a general oversight over good governance practices, while the senior management should look after the internal controls. The banking supervisors should promote good governance practices in banks and assess from time to time the quality and adequacy of such practices. It is expected that the combination of all the three aspects of good governance principles will contribute to form a sound and solid framework of governance in banks.

The Basel Guidance Paper has identified eight principles of good governance to be followed by boards and senior management of banks. They are as follows:

1. Board Qualifications, Capabilities and Responsibilities
    a. Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
    b. They should also be able to promote bank safety and soundness, understand the regulatory environment and ensure maintaining a cordial relationship with regulators.
    c. The boards should have an adequate number of independent directors who are capable of exercising objective judgment independent of the views of management, political and inappropriate outside influences.

2. Board's role regarding bank's strategic objectives and corporate values
    a. The board should approve the bank's strategic objectives and corporate values.
    b. The board should also set standards to be followed by the bank and clarify corruption, self-dealing and other illegal, unethical and questionable dealings by both board members and the staff.

c. Employees should be encouraged to take the unethical or illegal practices directly with the board.
d. The board should watch out the practices that would diminish the quality of corporate governance and encourage the management to set standards for same.

3. Lines of Responsibility and Accountability
   a. The board should set clearly defined lines of responsibility and accountability throughout the bank.
   b. The board should oversee activities and management actions
   c. The senior management should delegate to the staff, promote accountability by them and be responsible to the board.

4. Ensuring oversight by senior management
   a. The board should ensure that there is appropriate oversight by senior management consistent with the policy of the bank
   b. Senior management should have the necessary skills to run the bank, oversee the line managers' activities without interfering in micro level management and establish systems of internal controls.

5. Auditors and internal control functions
   a. The board and the senior management should effectively utilise, for the good management of the bank, the internal audit function, external audit function and internal control function.
   b. The board and senior management should give due recognition to the internal audit and internal controls, make the internal auditor an independent entity and take early remedial action when internal audit highlights lapses in management or internal controls.
   c. The board and senior management should give due recognition to external auditors, ensure that the auditors understand their functions, get external auditors to review the adequacy of internal controls, and have a regular dialogue with external auditors to assess the operational procedures of the bank.

6. Board and key executive compensation
   a. The board should ensure that the compensation policies and practices of the bank are consistent with the bank's corporate culture, long term objectives and strategy and its control environment.
   b. The board, while approving of compensation policies, should also avoid incentives for excessive risk taking by the staff.
7. Transparent governance
   a. The board and the senior management should ensure that the bank is managed in a transparent manner.
   b. Full disclosure should be made by the bank in all its public communication

media (web, annual reports or periodic special reports) and reports to the regulators about –

i. The board and senior management structure
ii. Basic ownership structure and the organisation structure
iii. Incentive structures and remuneration policies
iv. Code of business conduct and the ethics code
v. Policies related to conflicts of interest and related party transactions
vi. If it is a state bank, the policy of state ownership and relationship with the state

8. Know your operational structure
   a. The board and the senior management should understand the operational structure of the bank fully and its operations in different jurisdictions or structures that impede the transparency of the affairs of the bank.
   b. In every operational or jurisdictional structure which the bank has employed for legitimate business purposes, all types of risks emanating from such structural arrangements should be fully understood and assessed regularly in order to take measures for mitigating the same.

On the side of banking regulators, the Basel Guidance Paper has recommended a number of actions which regulators should take with regard to the implementation of a good governance programme in banks. For this purpose, the Guidance has emphasised that the regulators should consider good governance regimes as a part of their depositor protection measures. Hence, they are as important as the other prudential regulations which the regulators have enforced on banks and should see to that they are fully observed or complied with by banks. Hence, as in other prudential regulatory measures, the regulators should be proactive, thoughtful and insistent when they implement good governance measures in banks. It requires regulators to evaluate the implementation of good governance policies and practices by banks, assess the quality and adequacy of banks' audit and internal control functions, identify risk factors arising from the overall group structures of banks and bring to the notice of banks promptly any weaknesses or loophole in their governance policies or practices. These are all 'good supervisor-behaviour principles' which a responsible and understanding supervisor should follow. The regulatory mechanisms which regulators have brought to existence as mandatory regulations to be followed by banks are a step ahead of what the Basel Guidance Paper has recommended.

Can Regulations alone Save Banks?

The above principles, and also the regulations framed by banking regulators, on good governance principles have laid down a comprehensive operational framework to be followed by both boards and the senior management of banks. They include mostly what the boards and senior management should do and, to a lesser extent, what they should not do in planning, announcing and executing a bank's operational strategies. They obviously lack the moral and ethical side of managing banking businesses, the most important part of handling the moneys owned by others and temporarily handed to them for either safe keeping or profitable investment. If the members of the boards and senior management have not cultivated these ethical and moral attributes in them, no amount of regulation could put into practice an effective governance framework in banks.

The recent events in both Sri Lanka and abroad have revealed that board members and senior managers had displayed a lack of these moral and ethical attributes, when they ran banking businesses. There have been a number of instances where both parties had deviated from the cherished corporate values which banks had announced in their annual reports. The main theme enunciated in those values had been that board members and employees should always work according to what their 'conscience' would dictate to them. It requires them to make a critical assessment of every action before they take such action, in the light of the corporate values and the moral and ethical foundation on which those corporate values have been framed. The question they should ask themselves is 'am I doing the right thing?'. If the answer is in the negative, they should desist from taking such action, however much such action would bring profits to them as well as to the bank.

Good governance principles require both board members and senior managers to be skilful and competent in handling the jobs they are required to perform. Both these groups should, therefore, make an honest assessment of themselves before agreeing to function as a board member or a manager, as the case may be. If they feel that they do not have the required skills and competencies, they should then ask the question whether they could acquire them within a reasonable period of time. They should assume the positions, only if they could do so.

Even after accepting a position, it is necessary for them to involve themselves in a continuous learning programme. The knowledge base of the world is changing very fast today and, as a result, what one knew yesterday would soon become obsolete even before he gets a chance to use his knowledge. Hence, no one could safely rely on his previous knowledge base to handle the problems that he may face in the current period. The solution to this problem is to keep oneself updated all the time so as to acquire the competencies and skills needed. It is a self discipline and that discipline has to be cultivated in all sincerity. In the case of board members, if they have acquired the required knowledge on a continuous basis, then, they could act independently of the management views and dictates of the chairmen. In the case of the managers, such an updated knowledge base will help them to assess the business risks properly and take the required mitigating measures. Thus, a learning culture should be cultivated in banks with appropriate recognition of those who have actually acquired new knowledge and taken action to disseminate that knowledge to others.

Truthfulness and honesty are two other attributes which board members and senior managers should cultivate in themselves. They should neither be defensive nor be offensive when they are confronted by others with queries, questions or criticisms. From the public announcements which banks and even regulators make from time to time, one could infer that the true purpose of such announcements are not to clarify grave areas, but to take either defensive or offensive positions against the critics. There have been instances where organisations have even gone to the extent of slandering their critics, instead of answering the criticisms levelled against them. Approving of such actions of organisations, overtly or covertly, would not befit board members or senior managers as persons honestly seeking to improve the governance in their banks.

One mistake which board members and senior managers often do is to ignore or endorse small lapses in the belief that such lapses are not strong enough to make a significant dent to the bank. This is a wrong approach. Small lapses too are lapses, even though they may not make a material impact on the overall operations of a bank. A lapse, however much it is small, has the tendency of multiplying by itself into a huge lapse that may create a material impact on a bank one day. It is the duty of senior managers to be watchful of such small lapses and take action to prevent their recurrence. These lapses take the form of extravagance in expenses, improper promotions either on political or personal grounds and pilferage and abuse of banks' resources. They contribute to loosen the tight ethical and moral fabric which a bank may have woven for itself and create an environment that fosters bad behaviour at all levels across the bank. Once an institution has been driven to degeneration, no amount of good work it may do later in order to rescue it from the depths may be effective or successful. A bank cannot run this risk at all, because it handles other people's money and it has a sacred duty to protect such money.

It is apparent that regulations or sound principles alone cannot install good governance policies or practices in banks. The people who manage banks, namely, board members and senior managers, should be guided by a set of inviolable moral and ethical principles. If they are not honest to themselves, then, the regulated governance principles which banking regulators have introduced to banks become totally purposeless.

A Summary and Conclusions

Good governance principles in banks have come to the forefront of banking regulations in the recent past after several banks had failed or encountered difficulties. Diagnostic analyses of the causes of such bank failures have revealed that there had been blatant lapses in the governance structures in those banks leading to mismanagement, abuse of power and resources and mishandling of investors' funds. Hence, in the style of a global consensus, banking regulators throughout the world took action either to tighten the prevailing governance requirements or to introduce new requirements on banks.

It is the ultimate responsibility of boards of directors of banks to oversee the establishment of a proper good governance structure in banks. The senior management should cooperate with boards in introducing such systems. However, due to the general protective attitude which the banking regulators have taken towards banks and the unsatisfactory resolution of the principal-agent problem, there is a natural tendency in banks for the violation of the good governance principles by both the board members and the senior management.

The guiding principles which the Basel Committee has recommended and the regulatory mechanisms which banking regulators have enforced have included a comprehensive operational framework for good governance in banks. However, they lack the needed ethical and moral base on which banks could build a self-practised governance system. Such a system could be put in place only if the board members and senior managers are honest to themselves and guided at all times by their own conscience. This is the necessary and sufficient condition for building an effective governance system in banks.