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CHAPTER 4

DETERMINANTS OF CORPORATE GOVERNANCE IN BANKS

Introduction

In most cases, banks are large and organizationally complex corporations. Effective corporate governance in banks is the basis for achieving and maintaining public confidence in the banking system and constitutes a critical factor for the proper functioning of individual banks as well as the entire economic system. Corporate governance is an ambiguous concept as there is no single model or theory describing it. Models of corporate governance are divided into financial and social [Wit and Meyer, 1998]. The financial model of corporation focuses on the instrumental representation of the goals of the owners and pays particular attention to economic effectiveness – a company and its components become instruments to achieve it. On the other hand, the social model of corporation accentuates the importance of stakeholders and the necessity to balance their needs in the long term as a condition of survival. The social model of corporation assumes that corporate governance is a concept that refers not only to the owners, but to all stakeholders of the company.

In the case of banks this issue is even more complicated because sometimes they can be both an object and subject of corporate governance. Weak corporate governance may result in a bank's failure and in the loss of confidence in the quality of its management.

1. Definitions of corporate governance

A bank's corporate governance determines its principles of organization and functioning and defines its internal and external relations. It indicates the fundamental relationships between the owners, top management and external supervi-

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sion bodies as well as the bank's clients and social environment. It presents the essence of using good corporate practices and their critical impact on strategic management, and, what is typical of banks, on the management of banking operations, especially in the area of risk management and compliance with the law.

The mechanisms of corporate governance involve economic and legal institutions which are prone to change as a result of political processes. A. Shleifer and R. Vishny define corporate governance as a set of methods designed to guarantee investors (suppliers, shareholders and creditors) a return on their investment [Shleifer and Vishny, 1996]. Another definition describes this concept as a system by which companies (corporations) are directed and controlled [Cadbury, 1992].[1] Corporate governance involves a set of relationships between a company's executive staff, governing bodies, shareholders, and other stakeholders. Corporate governance [OECD, 2004] should provide proper incentives for the governing bodies and executive staff to pursue objectives that are in the interest of the company and its partners/shareholders; it should also facilitate effective monitoring. An effective corporate governance system – within an individual company and across the economy as a whole – helps provide the degree of confidence that is necessary for the proper functioning of a market economy, thus encouraging companies to use resources more efficiently.

One can quote various classifications of corporate governance systems. M. Jerzemowska [2002], while indicating external and internal systems of ownership and control, defined the Anglo-American model as an external one, and the systems adopted in Continental Europe and Japan as internal. The board of directors (combining the functions of a supervisory board and a management board) found in the Anglo-Saxon system plays a fundamental role in top level decision-making. In principle, representatives of owners generally do not participate in a company's management bodies; they act as observers, and now – in the face of the crisis – monitor the actions of the management bodies. The role of banks is very limited in this respect, and essential for the operation of a corporation are the capital market and the external market for corporate control.

In the German model of corporate governance, the non-executive function of the supervisory board is clearly distinct from the executive function of the management board. German banks, as opposed to American banks, hold an overwhelming part of shares of German companies and play a decisive role in managing the companies (mainly by having seats on supervisory boards and by influencing manage-

[1] B. Wawrzyniak places corporate governance above owner supervision and company management. More models of corporate governance can be found in Lis and Sterniczek [2005]; Dobija and Kołądkiewicz [2011].

ment boards by representatives of banks). It is assumed that managers from the banks have the knowledge, relevant experience and ability to use the influence of the banks they work for. They can also work as consultants for the management board. Management boards try to participate in the work of supervisory bodies and representatives of financial institutions as these institutions can be used as sources of capital and, furthermore as communication channels with other companies through informal networks of members of supervisory boards.

2. Corporate governance in banks

Public confidence is the basis for the functioning of banks [Korenik, 2009].[2] Therefore, banks are subject to statutory regulations to a greater extent than other economic entities and legislation is an essential factor in the development of bank management systems. Other factors resulting from the general strategy and philosophy of the functioning of the banking business seem to be subordinate to legislation [Büschgen, 1997, p. 12]. Generally, banks have complex and often very large groups of stakeholders. They have restrictive regulations and are monitored by banking supervision and rating agencies. Banks are subject to international guidelines and recommendations, and those which are publicly traded companies fall under additional regulations (e.g., concerning information governance). Banking corporate governance has several aspects. On the one hand, corporate governance concentrates on the classical approach to relationships between the owners and management of the bank, including the theory of agency [Ross, 1973, pp. 134–138; Jensen and Meckling, 1976]. This is reflected in analysis of the powers of supervisory and management boards (boards of directors in the one-tier model), compliance with the law and the organization of the management system. On the other hand, corporate governance is a component of a larger system within which banks are subjected to external influences affecting standards related to capital, risk management, and bank security, the latter being reflected in the system of bank management, subjected to external regulations of banking supervision (in Poland, the Polish Financial Supervision Authority).

There is also a third dimension of corporate governance in banking – banks influence their debtors and their actions. It is a very important factor in the corporate governance system, reflected in the theory of agency concerning debt (particularly evident in the German model of corporate governance presented above).

[2] The author indicates internal responsibility (microeconomic, legal, financial, ethical, to the customer, organizational) and public responsibility.

3. The formal structure of corporate governance

From the standpoint of the formal management structure of a commercial bank and the functioning of the corporate governance system, of greatest importance are the rules defining the principles of the development, organization and activities of banks defined in the Banking Act, regulations of the Polish Financial Supervision Authority, the Commercial Companies Code, the cooperative law, and other regulations, also international, etc. Under corporate governance, a bank's statute defines the structure and organization of the bank, the procedure to submit declarations on the rights and obligations, own funds, the principles of creating and using special funds, and the principles of financial management [The Banking Law, 1997]. A bank can be established when own funds are ensured and the entire initial capital is collected. The amount of capital should be adequate to the type of anticipated activity and its scale; the bank must also have an appropriate material base. While analysing corporate governance in a bank, one should pay attention to its founders and candidates for positions on the management board, including its president, who must be a guarantor of safe and stable management.

A special role is played by ownership supervision due to many formal regulations related to the "quality" of the owners and of the capital contributed by them. Article 9 of the Banking Act [Journal of Laws, 1997] states that the management board of a bank shall design, implement and ensure the operation of the management system. The supervisory board of a bank shall supervise the implementation of the management system and assess its adequacy and effectiveness. The proper division of competence and authority between the supervisory board and the management board is an important issue. The lack of such a division leads to many conflicts, which often result from misunderstanding of the function of the supervisory board. It has already been noted that banks must have risk management and internal control systems. Under the risk management system, a bank is obliged to use formalized principles and procedures of risk management; moreover, it sets limits for reducing risk, uses management reporting systems, builds organizational structures adequate to the risk and takes supervisory measures related to risk management in its subsidiaries. Under the internal control system, measures are taken to promote the effectiveness and efficiency of a bank's operations, ensure compliance with the law and other regulations, and guarantee the credibility of financial reports. Considering organizational structures, there is a legal obligation to establish an organizational unit (internal audit) responsible for independent and objective analysis of the adequacy and effectiveness of internal controls as well as for the examination and evaluation of the bank's management system. The in-

formation thus produced is addressed to the bank's supervisory board. The supervisory board can additionally strengthen its potential in this respect by appointing an internal audit committee from among its own members to cooperate with and supervise the audit unit functioning under the bank's management system.

The internal dimension of corporate governance concerns the relationship between the owners of the bank and the bank's management. This aspect is also reflected in the theory of agency and the resulting agency costs theory. The agency relationship involves agency costs which are enormous in banks due to their very complicated structures, excessive risk taking, evasion of responsibility resulting from frequent group decision-making (Asset and Liability Management Committees, risk-management committees, loan committees, etc.), and generous remuneration of executives (often unrelated to the actual performance of the bank). This is accompanied by asymmetry of information, which means that people in different places of the organization have different pieces of information and undertake rational decisions according to those pieces and based on their own point of view. Commercial banks are an excellent example of a more complex structure of information asymmetry resulting from the presence of regulations which banks have to respect [Ciancanelli and Gonzales, 2000]. According to D. McNaughton [1995, p. 18], the supervisory boards of commercial banks should normally:

- Approve large loans or those which depart from the accepted rules of the bank's credit policy
- Approve major investments and sale of assets and compensation programs
- Prevent "self-serving" practices (a bank financing transactions of the members of its own board) as well as preferential transactions with persons associated with the bank
- Establish an audit committee to review financial statements and maintain internal controls
- Create an integrated policy in the bank regarding finance, credit, and personnel matters

Of importance is leadership [Davis, 1985, p. 20] as well as a clear vision of the future and a deeply rooted organizational culture, which should be a permanent element of operations executed by the management boards of banks.

4. Corporate governance in the recommendations of the Basel Committee

The principles of good corporate practices [BCBS, 2006, pp. 6 - 19] formulated by the Working Group of the Basel Committee (Basel Committee on Banking Supervision) in 2006 indicate that corporate governance involves the allocation of authority and responsibility and defines the manner of managing the bank, sets the bank's objectives and strategy, sets forth the principles of remunerations in line with long-term objectives, clearly distributes responsibility in the whole organization, determines the bank's risk tolerance/appetite, protects the interests of depositors, meets shareholder obligations and the expectations of other stakeholders, and ensures that the bank will operate in a safe and sound way, honestly and in accordance with applicable laws and regulations. A bank should conduct a risk management function through the actions of specially appointed organizational units, including the Chief Risk Officer (CRO) who has considerable standing and is guaranteed independence, has sufficient authority, resources, and access to the management board. Risks should be identified, assessed, and monitored on an on-going firm-wide and individual basis, and the system should adapt to the environment.

An important priority is to build transparent structures, avoiding excessive complexity which might hinder the effective implementation of corporate governance. The application of principles of corporate governance must be pursued in a manner consistent with the applicable national laws, regulations and codes.

The Committee recognizes that some countries have found it appropriate to adopt a legal framework and standards (e.g. for publicly traded firms), as well as accounting and auditing standards which may be more extensive and prescriptive than the principles set forth in the recommendations.

Due to differences in the models of corporate governance in different countries, the recommendations do not impose a single system of its organization, respecting the existence of one-tier and two-tier board systems.

Staff members should also be encouraged to disclose information they believe evidences illegal or unethical practices, as such practices may adversely affect the reputation of the bank. Whistleblowing procedures should provide protection against reprisal and ensure confidentiality to eliminate threats to employees who inform about substantial dangers the procedures should also build safe ways for direct and indirect communication with the top management.

It is important to maintain a balance between tasks, powers and responsibilities. The organizational structures of a bank should facilitate effective decision-making and an appropriate quality of management in accordance with the long-term goals, strategy and financial standing of the bank and make it possible to regularly monitor the performance of top management, and replace the management if necessary.

The supervisory board as a whole and its individual members should have appropriate experience, competence and personal qualities to fulfil their role effectively. This also applies to the management board; its members should have knowledge of finance, accounting, loan granting, banking operations and payment systems, strategic planning, communication, risk management, internal supervision, regulations concerning supervision and compliance with these regulations. The management board should also understand local, regional and, if necessary, global economic and market forces as well as the legal and regulatory environment.

The bank should have an adequate number and appropriate composition of board members. The bank should identify and nominate candidates and plan their succession. To ensure the independence of candidates the recruitment process should be as extensive as possible and as justified. Independence of the supervisory board can be enhanced by participation of qualified non-executive directors. It is also necessary to pay attention if the candidates are able to commit the necessary time and effort to fulfil their responsibilities, and they must not be engaged in any conflict of interest. In its conduct, the supervisory board should set a good example of appropriate implementation of corporate governance, which should be assisted by the board's proper structure, size, frequency of meetings, and the use of committees. A key role in the functioning of the board is played by its chairman, who should have the required experience, skills, and personal qualities to fulfil these duties, and should encourage critical discussion during the decision-making processes. More and more banks require their chairmen of the supervisory board to be a non-executive member of the board. If the roles of the chairman of the supervisory board and the president of the management board (CEO) are not separated, it becomes particularly important to ensure effective supervisory mechanisms and the possibility to present independent opinions.

The recommendations suggest using supervisory board committees. Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures; furthermore, it may be useful to consider occasional rotation of chairmanship of such committees.

An audit committee is required in every bank. It is responsible for ensuring supervision over the bank through internal and external auditors and for cooperation with auditors, ensuring that the management board shall take the necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations and other problems identified by auditors. The audit committee should establish an accounting policy and accounting practices for the bank to pursue. It is necessary to assure the participation of independent directors in the work of the committee.

Every large bank should set up a risk committee responsible for advising the board on the bank's risk tolerance and for overseeing the implementation of strategies in this area, in particular managing the bank's capital, liquidity, credit risk, operational risk, market risk, compliance risk, reputational risk and other risks. The recommendations also suggest appointing other committees, in particular compensation, nominations, and ethics and compliance committees. The recommendations present extensively the issue of conflicts of interest, pointing to risks in this area. They also show situations involving capital groups, where the whole responsibility for the compliance of subsidiaries with corporate governance is borne by the parent company.

The application of principles of corporate governance in the area of management board activities should ensure that the bank's activities are consistent with its strategy and principles of risk management and that the members of the board meet the necessary experience, competence, and credibility requirements in the areas they are responsible for. While designing the bank's structure one should avoid creating excessive and unnecessarily complex structures, and ensure an effective supervisory system for founding subsidiaries and supervising their activities, and ensure the transparency of operational risk management. Ensuring transparency is also necessary in the relationship with shareholders, depositors, and other interested parties and market participants, who are additionally encouraged to actively participate in the system of the bank's corporate governance: shareholders through active and informed exercise of their rights, clients through the use of such banks that guarantee them the expected level of the services and by avoiding banks that are poorly managed, external auditors through effective communication with the supervisory board, management board, and supervision in the bank, and sectoral associations through the promotion of good practices and agreements concluded in this field.

Professional consulting companies can be helpful in the implementation of sound practices of corporate governance; governments can contribute through legislative initiatives in this area; rating agencies through assessment of the way

corporate governance affects the characteristics of bank risk; regulators of the stock market, stock exchanges, and other organizations by disseminating information about compliance with principles of governance in banks; and staff members through promoting employee whistleblowing.

5. Corporate governance in the light of the New Capital Accord

On April 1, 2007 the resolutions of the Polish Financial Supervision Authority implementing Directives 2006/48/EC and 2006/49/EC of the European Parliament [2006a, 2006b] and of the Council of June 14, 2006 (15), i.e., the regulations of the New Basel Capital Accord (NCA), entered into force in Poland. The accord consists of a set of rules and recommendations significantly affecting key management processes at banks, in both the strategic and operational spheres. The strategies and policies adopted by banks are updated annually and are subject to approval by the management board and the supervisory board (in Poland, a two-tier corporate governance system is in force, and top management is divided between these two bodies). The resolution of the Polish Financial Supervision Authority KNB No. 4/2007 [PFSA, 2007] states that banks are required to maintain an internal control system covering all bank organizational units. Similarly as in the case of the risk management system, banks are required to develop and implement a policy and procedures of internal control approved by the bank's management and supervisory boards. The NCA applies broadly to banks, subsidiaries and significant minority investments (in banks, various other financial entities), insurance institutions and major capital investments, as well in other non-financial entities.

The New Capital Accord consists of three pillars. The first one defines minimum capital requirements for banking institutions. These requirements are set within the framework of three basic risk types present in the banking business: credit risk, market risk, and operational risk. Emphasis was put on the tasks of corporate governance and supervision in the sphere of functioning of the internal assessment of risk and its application. One should take into consideration the scenarios which assume a negative impact on the bank's economic situation as well as an assessment of the bank management's ability to overcome adverse developments. This applies mainly to economic crises.

The second pillar is based on four fundamental principles. The first one involves supervision performed by the bank's management board and supervisory board, a reliable evaluation of capital, and comprehensive risk assessment, monitoring, reporting, and an internal control system. The second principle involves

adequate risk assessment, capital adequacy, evaluation of the sphere of supervision, review of compliance with the minimum requirements and supervisory response. The third principle states that the supervisory institutions should require banks to operate under capital parameters which are higher than the regulatory minimum and the supervisory institutions should have the possibility to enforce it. The fourth principle envisages intervention in the early stages of potential risks – a specific preventive action involving immediate remedial measures if capital is not maintained at the appropriate level.

The second pillar stresses the importance of transparency, responsibility, communication and international cooperation. The second pillar consists of a process of supervisory review involving an assessment by supervisory institutions of internal capital adequacy and the application of the principles and processes of the bank's internal governance in order to verify its approach to determining the value of the capital it is obliged to maintain.

In accordance with the guidelines contained in the third pillar, credit institutions are obliged to disclose information on their risk profile and the capital conservation buffers held to cover the risk inherent in their activities. All important steps in the process of evaluation and risk assessment must be approved by the bank's board of directors (supervisory board); alternatively approval may be granted by the management board in conjunction with a committee appointed by the supervisory board. The management board must present to the supervisory board, or to the appointed committee, information on major changes or exceptions to the established principles of policy which affect the functioning of the bank's rating system. The management board should be familiar with the structures and functioning of the NCA. The management board's tasks include also the approval of major differences between the established procedures and the actual practice. Attention was paid to the importance and significance of reporting, its confidentiality and frequency. It was concluded that reporting should be an instrument ensuring mutual discipline of market participants.

Conclusion

Corporate governance in banks is strictly related to the fact that banks are public institutions which require effective legal, institutional, and customary foundations. One should emphasize the importance of formalized rules and principles of conduct, enforced by both the internal stakeholders of the bank and the increasingly important external stakeholders. In their actions, modern banks also take into account the social and financial models of corporate operations. These mod-

els must be followed by proper organizational structures and procedures, supported by adequate corporate culture ensuring appropriate standards and by incentives for professional and responsible conduct, which is essential for good governance. The leading role in this sphere must be played by supervisory and management boards (boards of directors), whose activities should serve as an example of application of corporate governance principles, preventing improper or unlawful actions, excessive risk taking and corruption and making sure that members of those bodies do not take advantage of their privileged position.

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