

Corporate Governance and Its Benefits: Does It Really Matter for Banks?

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Abstract

Corporate governance is one of the force that keeps all the pillars of a corporation and in turn, collectively that of the economy, in their places. Now, six years later, there is no doubt that if this elementary force is not made a subject of extensive research and practice, the world as a whole will inevitably succumb to the drastically changing environment of the 21st century, globalized and industrialized world and the threats it poses. We begin this paper by explaining why governance of banks differs from governance of nonfinancial firms and its importance in banking industry. We then look at some areas of governance: corporate governance principles, parties, boards, risk management, and market discipline. We discuss promising solutions and areas where further research is needed.

Keywords: Corporate governance, banks, financial institutions, organizational development and benefits.

1 Introduction

Of all the systems the world has known through the rise and fall of civilizations to modern day creation and liquidation of corporations, the most dangerous system (or the lack of it) has been “anarchy”, the opposite of which is the word “governance”. Corporate governance, in the simplest terms is a purposefully built structure of policies, norms and rules which govern corporations so as to make it fully functional in terms of its responsibilities to all its stakeholders. In 2009, the world watched in horror while news agencies broadcasted live, the tumbling down of numbers on international financial markets. Analysts have raised hundreds of questions as to what was to blame and the center of all discussion was “corporate governance”. It is the one force that keeps all the pillars of a corporation and in turn, collectively that of the economy, in their places. Now, six years later, there is no doubt that if this elementary force is not made a subject of extensive research and practice, the world as a whole will inevitably succumb to the drastically changing environment of the 21st century, globalized and industrialized world and the threats it poses.

2. Objectives of the Study

The Goal of this report is to understand and explain corporate governance and its elements and also identify why it is implanted in the Financial Institutions to increase efficiency. To do so, we also expect to,

1. Identify The rules and regulation related to Corporate Governance in Financial Institutions
2. Narrate the importance of good Corporate Governance
3. Research and detect to what extant Financial companies giving priorities to maintain a good corporate governance in their company in current situation
4. Proof corporate governance is the key to increase efficiency in an organization

3. Methodology

Our study has been a pursuit to understand what role corporate governance had in the running of the financial system, how it influences the effect of business processed and ultimately the economy. Our study approach is research based. There is involvement of both primary and secondary data's. We had prepared a set of around 23 questions and asked the interviewee to answer them. Based on this information we have conducted questionnaire survey and made findings from it.

Again our second step research has been done with the information that we collected from Annual Reports of 18 Banking Financial Institutions and from various web pages. Based on this information we have conducted another survey with the use of 17 variables related to Corporate Governance. This is a scoring based research or survey. This 17 variables are also the elements that Security exchange Commission (SEC) of Bangladesh make it mandatory for all the Banking Financial Institutions to show in their annual reports. However with this data's we have calculated mean, standard deviation and correlation matrix of all the banks. In addition we have also calculated the percentage of disclose information, minimum and maximum number of various variables. Based on this we have made another findings. Finally we have relates both findings.

3.1 Data Source

- **Primary:** The primary information's are gathered by interviewing the FAVP & Sub-manager of the Trust Bank LTD (Banani Branch).
- **Secondary:** Information's are collected by Annual reports of Financial Institutions, reference books, magazines, journals, browsing various WebPages and also visiting the organization.

3.2 Report Design

We begin by elaborating the general concept and principles of corporate governance, its history and framework .Later parts are divided into the specialized role of corporate governance in the financial sector, identifying how it is different. We delved into the problems with the existing model of corporate governance and what control measures can be taken, describing fully the segmented oversight system and functions. We next focused on more specific roles of corporate governance such a risk management, incentive management and external regulation.

The aim was to conduct two types of survey to justify the reality as well as to get as many problem related to Corporate Governance in our Banking Financial Institutions. We had put more emphasis on the survey results, findings and recommendations in our report. We have used computer to type the entire report and also by browsing the internet to gather secondary information. Wide ranges of books, journals etc. are available on this topic and we have acquired ideas from there but own creativity and proper group work has got the highest priority to prepare.

3.3 Limitations

- Not all the banking Financial Intrusions of Bangladesh disclose information (Annual Report) on web. It is not only our limitation but also a concern of inefficient Corporate Governance practice of those banks.
- Primary survey (questionnaire) findings could have been more accurate with involvement of few more institutions.
- Different schools of thoughts regarding the role of corporate governance and its role in the financial crisis.
- Scarcity of impartial research done to evaluate the different schools of thought.
- Lack of research on the complexities of production ,use and quality of information in financial institutions
- Lack of time and opportunity to do our independent survey of financial institutions.

4. Review of Related Literature

A combine finding from some related research has been discussed in this part of the report. It is roughly seen that different research about corporate governance has shown different prospects of this topic. A wide range of point of view can be followed while studying corporate governance.

Most research highly support that financial companies are more open to their Shareholders then non-financial and government organizations. That means Financial Institutions are more concern about shareholders right, disclosures of information and transferences of financial information.

“The corporate governance framework should protect and facilitate the exercise of Shareholders’ rights.”¹

Organizations are more efficient if there is an independent and competent board. A clash of decisions has been found in terms of board size. However less than five and more than twenty board members are not supported by any of the research. Certain part argue that the low number of board members is key to success for financial institutions if there is consideration of profit and overall management. They also support less directors with huge expertise of the business. They believe more directors means more different decisions might have more clash. Again it is also found from other research that different members from a board should have skills in different sectors of a business and thus a combine merit can lead the firm toward efficiency.

For an efficient and effective board, Independent directors are a major criteria and it is one of the underlined area of various research. The number of independent directors might be the proportionate of total board members or can be a fixed number but its batter to have maximum three. Almost all support that independent directors should be appointed by elected directors.

Financial reports should be prepare in accordance with the international accounting standards and both internal and external audit must be done separately and sincerely. Researcher has given a high priority on this part because shareholders invest in any organization by looking at the financial position of the firm.

Some early observation related to corporate governance states that board meetings is an integral issue to promote efficiency for any organization. it also supported that more the meetings have positive impacts towards good governance .Attendance of all the board of directors is needed.

¹OECD Principles of Corporate Governance, (2004)

In terms of elements of corporate governance most of the observations shown similar results that it must have good board practices, it should control environment, disclosures must be transparent, shareholders right should be well defined and board should have high commitment.¹

Disclosers should be made of arrainging annual general meetings as well as extraordinary general meetings. The major ways to communicate with shareholders and potential investors (annual report) should be supported by various ways of communication that is convenience to them.

Two related findings have been shown below in two different countries:

“Board size and independence, audit committee size and diligence and ownership structure in the performance of banking industry in Nepal. Various studies have been done in context of developed economies however study regarding corporate governance and bank efficiency is very rare in context of developing countries. The findings of this study have important implication for bank in Nepal since it is found that strong board size and audit committee size and higher proportion of independent director in audit committee, lower frequency of board meeting and lower ratio of institutional ownership has better influence in Nepalese banks. The result about audit committee diligence and efficiency suggests that effectiveness of audit committee meeting may be hampered with overloaded agenda, which recommend the importance of quality meeting for the efficiency of firm.”²

“The findings reveal that the presence of institutional shareholders in the firm might have a negative influence on the efficiency and performance of the management. Generally, institutional shareholder possesses facilities, expertise and experience in a firm but they might not interfere in the decisions related to the firm. Cultural organizations and those dependent on the government do not have enough incentives for the interference not only because of the lack of accountability but also the essential expertise required for investment. The lack of the expert members in the board can lead to a decrease in the efficiency of the board. Additionally, it is a motivation for the short-term vision about the investments. Finally, institutional shareholder is a challenging concept by considering the less efficiency and manager’s performance.”³

5. Conceptual & Theoretical Framework

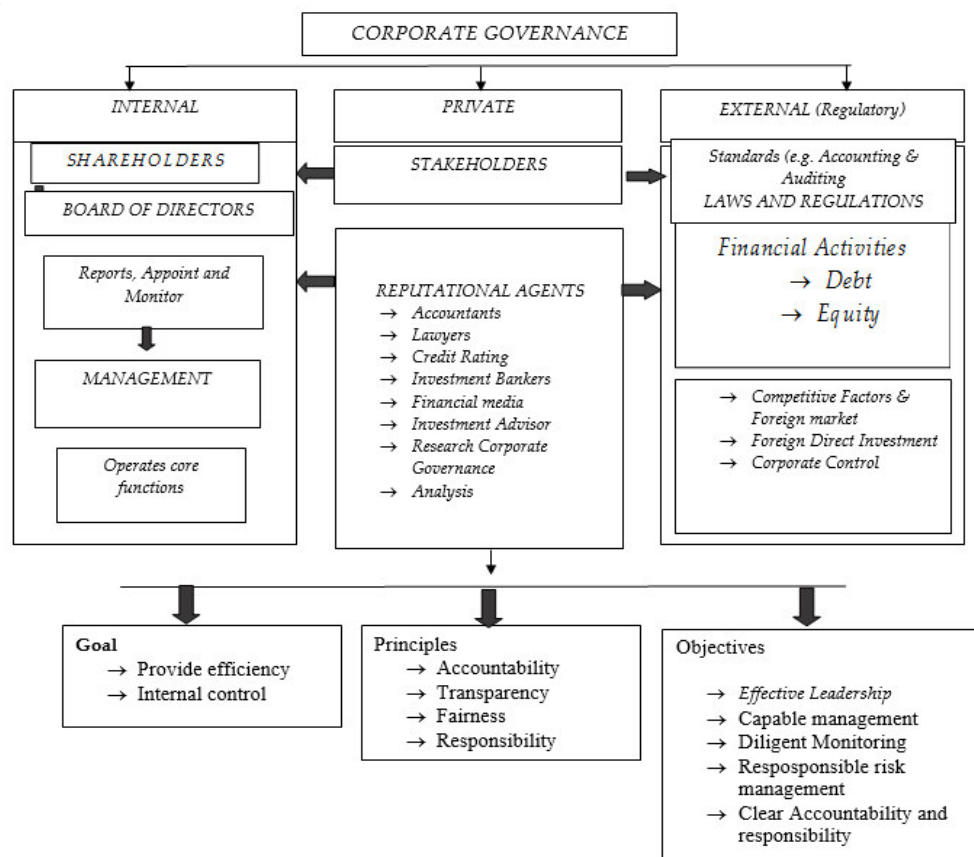


Figure 1: Conceptual and theoretical framework

¹Introduction to Corporate Governance, Corporate Governance Board Leadership Training Resources Kit (2008)

²Ravi Prakash, Sharma Poudel and Martin Hovey (May 2013)

³Mahmood Moeinadin, Mohsen Karimianrad (2012)

Introduction To framework:

Corporate governance basically has three control systems. Those are Internal Control system, External Control system and private.

1. In Internal Control System the shareholders are specified necessary reports, information to guide them in appointing and re-appointing an efficient Board of Directors who manage the daily operations of the company. There is a straightforward distinction between the owners and the stakeholders, the employees, the financiers who empower the Board of Directors to run the company efficiently. Thus, the first principle in the frame work is that there is clear cut distinction between the Ownership and the Professional Management of the Company. And all the stakeholders are known about the day to day operations through various reports and information.
2. In private sector the promoter group who have considerable stake in the company. Their main objective is to maximize the wealth of the shareholders. The Distributors or the channel partners are the stakeholders as well, their main objective is to be part of a value chain and make timely deliveries across the country. The Customers and the employees are also the stakeholders where the customer's main objective is to get best quality product or service at the most competitive rate and the employee's main objective is to get the most lucrative salary and perks to motivate them to put in their very best.
3. In external control system all the external people are related who are from outside of the organization. Especially the regulatory authorities like SEBI and the Stock Exchange, auditors which would ensure that all the principles lay down are followed.

5.1 Corporate Governance

“Corporate Governance is concerned with holding the balance between economic & social goals and between individual and communal goals. The Corporate Governance framework is there to encourage the efficient use of resources and equally to require stewardship of those resources. The aim is to align as nearly as possible the interest of individuals, corporations and society.”

-Sir Adrian Cadbury

“Corporate Governance is an internal system encompassing policies, processes & people which serves the needs of shareholders & management activities, by directing & controlling management activities with good business savvy objectivity, accountability & integrity.”

- Gabriele O'Donovan

In other words Corporate Governance may be defined as a set of systems, processes and principles which ensures that a company is governed in the best interest of all the stakeholders.

It is the system by which the companies are directed and controlled. It is about promoting corporate fairness, transparency and accountability.

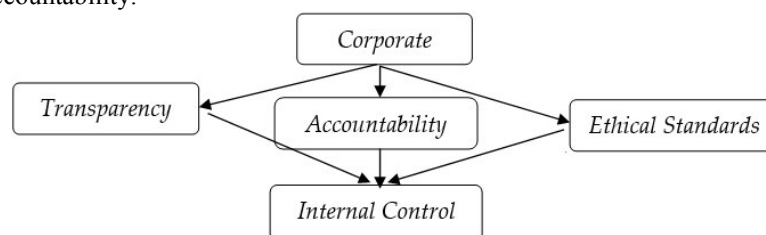


Figure 2: Relationship between corporate governance and internal control

5.2 History of Corporate Governance

Corporate Governance is an old problem! Adam Smith recognized Corporate Governance a long back. According to Adam Smith,

“The Directors of such (joint-stock) companies, however, being the manager rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partently frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less in the management of the affairs of such a company.”¹

The stone of modern Corporate Governance were most likely sown by the Watergate scandal in the United States. As a result of following investigations, US regulatory and legislative bodies were able to highlight the control failures that had allowed several major Corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 in

¹Adam smith, quoted by Jensen and Meckling (1976)

USA that contained specific provisions regarding the establishment, maintenance and review of systems of internal control.

This was followed in 1979 by the Securities and Exchange Commission of USA's proposals for mandatory reporting on internal financial controls. In 1985, following a series' of high profile business failures in the USA, the most notable one of which being the Savings and Loan collapse, the Tread way Commission was formed. Its primary role was to identify the main causes of misrepresentation in Financial Reports and to recommend ways of reducing incidence thereof. The Tread way Report published in 1987 highlighted the need for a proper control environment, independent Audit Committees and an objective Internal Audit function. It called for published reports on the effectiveness of internal control. It also requested the sponsoring organizations to develop an integrated set of internal control criteria to enable companies to improve their controls. Accordingly COSO (Committee of Sponsoring Organizations) was born. The report produced by it in 1992 stipulated a control framework, which has been endorsed and refined in the four subsequent UK reports: Cadbury, Ruttman, Hampel and Turnbull. While developments in the United States stimulated a debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990's led the Shareholders and Banks to worry about their investments. These also led the Government in UK to recognize that the then existing legislation and self-regulation were not working.

The issue of corporate governance became particularly significant in the context of globalization because one special feature of the late 20th century/21st century globalization is that in addition to the traditional three elements of the economy, namely physical capital in terms of plant and machinery, technology and labor, the volatile element of financial capital invested in the emerging markets and in the third world countries is an important element of modern globalization and has become particularly powerful. Thanks to the ubiquitous application of information technology, at the touch of a computer mouse, it is possible now to transfer billions of dollars across borders. The significance and the impact of the volatility of the financial capital was realized when in June 1997 the currency of South East Asian countries started melting down in countries like Thailand, Indonesia, South Korea and Malaysia. It was realized by the World Bank and all investors that it is not enough to have good corporate management but one should have also good corporate governance because the investors want to be sure that the decisions taken are ultimately in the interest of all stake holders. Honesty is the best policy is a fact that is now being re-discovered.¹

5.3 Parties to Corporate Governance

The most powerful parties involved in corporate governance include government agencies and authorities, stock exchanges, management (including the board of directors, the Chief Executive Officer, management, shareholders). Other influential stakeholders may include lenders, suppliers, employees, creditors, customers and the community at large.

The agency view of the company posits that the shareholder forgoes judgment control and entrusts the manager to act in the shareholders' best combined interests. As a result of this separation between the two investors and managers, corporate governance mechanisms include a system of controls proposed to help line up managers' incentives with those of shareholders. Agency concerns or risks are necessarily lower for a controlling shareholder.

A board of directors is expected to play a key role in corporate governance. The board has the responsibility of endorsing the organization's strategy, developing directional policy, appointing, supervising and remunerating senior executives, and ensuring accountability of the organization to its investors and authorities.

All parties to corporate governance have an interest, whether direct or indirect don't matter, in the financial performance of the corporation. Directors, workers and management receive salaries, benefits and reputation, while investors expect to receive financial returns. For lenders, it is specified interest payments while returns to equity investors arise from dividend distributions or capital gains on their stock. Customers are concerned with the certainty of the provision of goods and services of an appropriate quality; suppliers are concerned with compensation for their goods or services, and possible continued trading relationships. These parties provide value to the corporation in the form of financial, physical, human and other forms of capital. Many parties may also be concerned with corporate social performance.

A key issue in a party's decision to participate in a corporation is their self-assurance that the corporation will deliver the party's expected outcomes. When categories of parties (stakeholders) do not have sufficient assurance that a corporation is being controlled and directed in a method consistent with their preferred outcomes, they are less likely to engage with the company. When this becomes an endemic system feature, the loss of confidence and participation in markets may affect many other stakeholders, and increases the likelihood of political action.²

¹Dharma in Corporate Governance Chartered Accountant, (December 2003)

²Corporate governance and sustainability concept, (2013)

5.4 Principles

Accountability

The Code of Corporate Governance envisages accountability of the Board of Directors of the Company before all shareholders in accordance with the legislation in force, and is the governing document for the Board of Directors in issues related to strategy planning, administration and control over the Company's executive bodies.

Fairness

The Company undertakes to protect the rights of its shareholders and treat all shareholders on an equal basis. The Board of Directors enables its shareholders to receive efficient protection if their rights are violated.

Transparency

The Company shall provide timely disclosure of credible information on all the important facts related to its activities, including information on its financial condition, social and environmental measures, results of activities, ownership and management structures; the Company shall provide free access to such information for all interested parties.

Responsibility

The Company allows the rights of all interested parties visualized by the legislation in force, and aims at cooperation with such parties in order to provide steady development and ensure financial stability of the Company.

5.5 Why It Is Important

Corporate governance as we have previously noted is a framework of regulations, monitoring and amendments which play a crucial role in guiding organizations to realize their core functions i.e. their identities as profit makers, shareholder wealth maximizers, as well as a player in the socio-economy of the nation and of the world as a whole. Corporate governance is important in order to align all these functions. It sees to it that an organization does not neglect or undermine for example, its responsibility to act equitably towards all its stakeholders such as the customers, its employees as well as its environment in pursuit of making profit and increasing shareholder's wealth. The importance of this governance cannot be more emphasized than it has been by the economic crisis of 2008-2009 which rendered millions homeless, unemployed and devastated. Corporate governance is required because organizations need neutral well defined judgments to see to it that they are not taking more risk than is required, that they are serving the rights of external stakeholders by disclosing due information and because such actions need to be encouraged through motivation and incentives which corporate governance can provide.

5.6 Why It Is the Top Issue for Financial Institutions

To answer this question, we revisited our economics courses taken earlier during our university years. One of the first things we learned in micro-economics was that resources, whether it be of a nation or the world at large, are essentially scarce. The productivity of a nation depends on how efficiently it allocates scarce resources to produce the most value adding output. In an economy, the role of the financial institutions, especially the bank is to efficiently allocate scarce capital throughout the rest of the economy. It is the financial institutions through which government controls the money supply in the economy, it is the financial institutions, like investment banks which manage the investments in securities, which ultimately provide factor of production to the producing units of the economy and it is the financial institutions which provides leverage to these production units, insures them and underwrites their returns from investments. Thus financial institutions are of great significance in the production cycle of the economy because they are the intermediaries who facilitate and catalyze the motion of the economic wheel and failings in such institutions eventually translate into leakages from the economic cycle. Having said that, such crucial nodes of the economic wheel, if left unregulated will lead to distortions in allocation decisions, underestimate potentially risky ventures, lead to misrepresentation of financial performance and eventually lead to erosion in the future economic growth.

This idea is articulately expressed by Hamid Mehran and Lindsay Mollineaux in their 2012 study, named "Corporate Governance and Financial Institutions". The authors argue "This inattention (in corporate governance) is undesirable for achieving the goals of stability through innovation, which are laid out under our initial framework. As market monitoring decreases, it becomes likely that banks can increase their systematic risks, unnoticed which can lead to the greater instability of the financial system. Furthermore, when risk is not properly priced, financial institutions can receive cheap subsidized capital, which can lead to distorted capital allocation within the real economy, where potential investments are not properly evaluated for their true, risk

adjusted returns ¹

The 2008-2009 financial crisis was a good reminder of why financial institution regulations are imperative. First of all, financial institutions have high barriers to exit. Their liquidation does not only affect their immediate stakeholders but the public, who have deposits with them, or portfolio investments through them or hold leasing agreements with them. Thus they are as the Americans call it “too big to fail”, meaning in case of failure, the government will bail them out i.e. meet their capital needs and pay their liabilities to keep them functioning. This leads to a direct moral hazard and provides incentives to financial institutions to take unreasonable risks. Corporate governance if required to see to it, that this does not happen. Mehran and Lineaux suggest two ways of doing this: First, they can mandate the maximum level of risks that financial organizations can take and the level of disclosure of information to external players. Second they can motivate desired behavior through changing their incentives.² We will expand on this, as we move along this paper.

Finally, innovation in financial institution is essentially intangible, unlike in non-financial firms. Innovation mainly relates to selling of risks and remaining safe from the moral hazard as we have seen happening to deregulated banks in the US just prior to the financial crisis. Financial institutions sold housing mortgages to a huge pool to clients, regardless of their socio-economic positions and sold out their liabilities to investment banks who in turn sold out the liabilities to investors in CDS or Credit Default swaps, who invested in derivatives and other betting instruments. These investors were from all over the world. Insurance companies, that provided insurance for risky investments insured, all these investments and took on the risk of payment to a larger client base than could be handled. The large circulation of money through the economy was praised by treasury officials and despite repeated warnings from analysts, regulatory bodies refused to interfere and these huge financial institutions repeatedly received AAA credit rating from reputable credit rating firms like “Fitch”. The result was a huge economic bubble and ultimately burst leading to the biggest financial crisis after the 1930’s great depression. Families were uprooted, workforces were stripped off their jobs, firms faced bankruptcy and PhD holders were found on streets, begging for food and shelter.

No wonder, the authors assert “For each financial instrument that becomes a weapon of mass financial destruction, or creates an economy wide bubble, there is an underlying failure of incentives among executives of financial institutions, their owners and creditors, and their regulators. Corporate governance has the potential to identify problem spots where incentives are mismatched, in a way that could lead to undesired firm behavior or even system-wide instability.”³

5.7 Difference of Governance in Financial Firms & Non-Financial Firms

We know that the main function of a corporation is to maximize the shareholders’ wealth. While it has by law an obligation to society and environment, such duties are often considered ancillary to the return on equity financing that the firm capitalizes on. For financial institutions, this obligation extends beyond shareholders’ interests. Their stakeholder’s extend beyond their clients, employees and legal authorities. Their ultimate stakeholder is the economy, not just a portion of it, as is the case with non-financial firms. Accordingly, corporate governance in the financial sector varies, greatly from that of the non-financial sector.

Financial institutions like the bank are multi-constituency institutions, meaning depositors and bondholders contribute almost all of a bank’s capital, yet most decisions are taken by managers, boards, and shareholders. Bank executives do not have to seek permission from depositors before changing a bank’s risk profile.⁴ Since banks are usually protected by government confidence and therefore deposits are ensured, depositors and bond holders rarely feel the need to be updated on the financial performances of the bank or be familiar with their portfolio undertakings. Hence in this case the ones bearing the biggest chunk of stake are not active participants in the governance of financial institutions. Therefore there needs public auditing and regulators who safeguard the interests of these dormant creditors.

In case of financial institutions, many studies have observed that there is often a tradeoff between safety and soundness against innovation and improvement⁵. While in other firms such as the technology industry, innovation is tangible, that can be seen and felt by consumers, innovation in the financial industry often is implicit and involves heavy risk maximization. This leads to a conflict between private and public interests. Therefore corporate governance in financial institutions seek to balance the interests of public and shareholders and executives through putting a ceiling a risk and also allowing the people to be informed of the financial institutions they are involved with. On the other hand the governance of the non-financial firms may be left upon management, board members and top executives because in most cases their largest capital provider the very

¹Mehran and Lineaux, (2012)

²Mehran and Lineaux, (2012)

³Mehran and Lineaux, (2012)

⁴Betch and Bolton et al.(2011)

⁵Mehran and Lineaux, (2012).

people whose interests the firm is trying to maximize and therefore are not in conflict with public interests.

The second difference is in the issue of incentives. Since for a non-financial firm, performance can be easily based on shareholder's interests, incentives are not in conflict with the real value of firm's performance. But in the case of financial institutions, "performance is normally measured as a nominal value and not as a risk adjusted value". Top executives earn huge incentives, regardless of the risks they take and the effect of their financial activities on the economy, as long as the economy is good and their luck is paying off. This is not the case with non-financial firms where incentives of the management (bonuses) are often performance based and take into consideration a large variety of market measure adjusted internal ratios, to judge performance. Therefore corporate governance is exclusively required in financial institutions to base incentives on their contribution to the stability of the financial system rather than the nominal returns they are earning.

The third and the main criterion for difference between corporate governance in financial and non-financial sectors may be tied to their size and implication. As we discussed before financial institutions, specially banking corporations have high exit costs. Therefore governments take it upon themselves to bail out these banks and secure depositors' interests. Mehran and Mollineaux writes, "Banks have the unique ability to attract funding in form of deposits that are fully insured up to a limit and thus incentives to risk. Moreover, unhealthy banks are taken over by regulators instead of having to face bankruptcy in public courts. Assets are subsequently sold to another institution or in case of multiple bidders, to the highest bidder".¹

This deadens the added incentive for board members and trustees to adequately monitor their banks for risk undertaking and soundness of financial activities. Thus corporate governance in financial sector must be much broader and cover a lot more aspects and variables and market measures than in non-financial institutions.

The fourth aspect of difference lies in disclosure of information. Due to the unique nature of capital acquisition and utilization of financial institutions, they are required to be very transparent. More so, than non-financial firms. They must file a series of periodic reports with their regulators and update them as the data evolves. However, the authors point out, "the current regime of information disclosure is one of compliance and hence is strictly standardized."² There is no guarantee or internal requirement to make such information convenient, beneficial or easily accessible to the public. Corporate governance aims, or should aim, not only to ascertain that data is disclosed but to make them useful to key market players, which may not always be such a strict requirement in case of non-financial firms.

Financial institutions by their very nature are more complex than non-financial firms, they are prone to excessive risks and are in greater need to reveal information. "Much like electrical utilities or railroads, they are private sector firms whose healthy functioning is in the public interest."³ For such an entity, it is very difficult to set an ideal benchmark. The banking process must evolve through a series of ups and downs before the perfect mode of governance is identified. Therefore, governance in this sector is far more complex, involves more players and is subject to more scrutiny and monitoring than are their non-financial counterparts.

5.8 Systematic Problems of Corporate Governance

Having elaborately talked about the crucial role that financial institutions play in the overall functioning of the economy, it is evident that incentives play a significant role in governing financial institutions. It is sad and noteworthy that the current mode of corporate governance failed to anticipate, plan for or even stop incentivizing the global financial crash. It is noteworthy that the financial crisis was largely attributed by analysts to the extensive deregulation of banking institutions. With vision of "too big to fail" corporations, excessive unconsolidated reward system for top management and reckless predatory lending grossly increases in a deregulated banking system. Under such a system, unless reform is made, as the Governor of the Bank of England warned, there is a chance of another financial crisis in Britain.⁴ Under OECD guidelines there are four fundamental areas of systematic failure in corporate governance which contributed to the financial meltdown in 2008. They are:

- Executive Remuneration
- Risk Management
- Board Practices
- Exercising of Shareholders' rights.⁵

The OECD however asserts that while there are no structural flaws in the guidelines of principles, the

¹Mehran and Mollineaux, (2012)

²Mehran and Mollineaux, (2012)

³Mehran and Mollineaux, (2012)

⁴The Telegraph, (2011)

⁵Sun and Stewart et. al. , (2011)

implementation of those tenants by the corporations and regulators were to blame.¹

However there is a third category of analysts consisting of independent researchers , university professors and writers who asserted that the financial meltdown was directly attributable to flawed principles of corporate governance and systematic failures in finding the idea institutional structures . Some of the factors cited by these thinkers are, deregulated banking structure, self-governance, self-interest human behavior and shareholder's primacy.²

Simply put self-regulation put the banks in a position to exploit shareholders' wealth to maximize returns by a "greed is good" culture , self-interest oriented market outlook with stock prices as a basis of reward to CEO's and CFO's which ultimately led to large amounts of predatory lending . Lack of control on how much risk was being taken, investment banks pursued vast securitization of commodities and leverage which ultimately led to gross undermining of the interests of shareholders, creditors and the economy. In short the lack of effective intervention of corporate governance agents led to a financial anarchy. This is not just a flaw in the implementation of OECD principles but flaws in the very guidelines which failed to select the right regulators, proper rating devices and ultimately assumptions of a financial model, characterized by excessive trust in the "invisible hand" magic.

The structural and systemic problem with the current corporate governance model lies in its definition which is too narrow to justify such a complex, ubiquitous and essential sector as the financial institutions. As several researchers have pointed out, "The common understanding of corporate governance is often narrowly confined to the structure and functioning of the board and the rights of shareholders in corporate decision-making."³

However corporate governance, in order to be effective must answer crucial questions such as what is the vision and mission of the financial institution? Whose interests are they serving and how? Who is in control and how is controlling being done? How the risks and returns are measure and allocated?⁴Hence it is safe to conclude that corporate governance, in order to be effective must include a whole set of players in the broader economy." This arrangement must include regulators, stakeholders, markets and internal governance "⁵

The deregulated system has no provision for external forces of corporate governance to monitor and have control over corporations for the interest of stakeholders, markets or external regulators. It is limited to internal governance made up by directors, board members and trustees and hence self-interest and misallocations infest the corporate system.

The fact that systemic failure of corporate governance was to blame for the financial crisis may be controversial but it is a fact that a series of US amendments preceded the crisis. The deregulation of financial institutions followed a step by step process until financial anarchy was a culture in the banking industry.

In 1933, following the Great Depression, President Franklyn Roosevelt adopted a strict and conservative policy whereby financial institutions were to be rigorously monitored and controlled. Their investments, risks and returns were subject to strict oversight of regulatory bodies. However after 1980's , what Americans now like to call it, "Raegonimcs" or the principles inculcated by President Ronald Raegan which had its roots in financial capitalism crept in .

- In 1999, the US Congress passed the Gramm-Leach-Bliley Act, which repealed the Glass-Steagall Act of 1933 that separated commercial banks from investment banks.
- In 2000, the US Congress passed the Commodity Futures Modernization Act, which allowed the self-regulation of futures and derivatives, declaring that all attempts to regulate the derivatives market are illegal.
- Investment banks were permitted to substantially increase their debt level and leverage.
- Depository banks were permitted to move massive amounts of assets and liabilities off balance sheets into structured investment vehicles and conduits to hide their debts, insufficient capital and high risks taken.
- There was a lack of regulation over the shadow banking system that consisted of non-depository bank financial institutions to lend businesses money or invest in 'toxic assets' (such as subprime mortgage backed securities) with a significant high level of financial leverage.

(Disclaimer: The bullet points are directly taken from the source which is cited appropriately in the bibliography and were not rephrased in case the content is spoiled)⁶

The Anglo-American structure of corporate governance which was eventually adopted under the economic theories of neo-liberalism has crucial shortcoming which is the absolute exclusion of stakeholder governance, where major customers , suppliers , employees has major says in the decision making of

¹OECD,(2009)

²Chaukin,(2009)

³Monks and Minow,(2001); Clarke, (2007)

⁴Blair, (1995)

⁵Sun and Stewart et al, (2012)

⁶Sun and Stewart et al., (2012)

corporations .¹

Mehran and Mollineaux argue, “Boards and markets may want financial institutions from those desired by the society. We also describe market failures, such as moral hazards generated by government bailouts, and consider how these failures could incentivize market actors to be poor monitors and lax enforcers of market discipline”²

This type of deregulated approach to corporate governance is the market governance approach which is characterized by increased independence of the board and increased governance of market mechanisms, or the invisible hand, argues for by economists such as Milton Friedman. Following the financial crisis, while certain reforms are adopted like introducing independent directors, shareholder activists, and corporate governance guidelines and best practices³. It is highly debatable whether such reforms are sufficient. This is so because the above ideas are adopted assuming that the pre-crisis governance itself was not flawed but its implementation was to be blamed. However a large majority of analysts continue to think that increased reliance on market oriented corporate governance minus stakeholder governance is remain the eroding factor of modern corporate governance and will eventually lead to another major global financial crisis.

5.9 Mechanism & Control

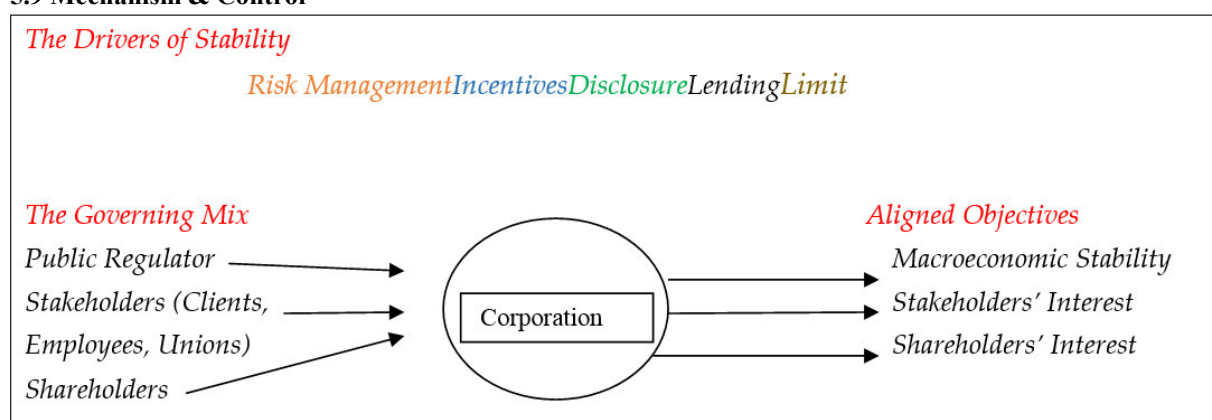


Figure 3: Framework of Mechanism & Control

As we discussed in the preceding sections, it is being suggested that corporate governance in the financial sector or even non-financial firms must be broken down according to the agents of governance. Regulatory authorities should monitor the extent of public order on corporations based on government’s rules and statutes. Market governance should use market forces such as demand and supply , market entrance and exits , market bids and contracts to make sure corporate behavior is disciplined Stakeholder governance is the direct and indirect control or influence over corporate business, decision-making and corporate behavior by key stakeholder groups who have direct or indirect interests in the corporation. Internal corporate governance is the institutional arrangement of checks and balances among the shareholder general meeting, the board of directors and management within the corporation, prescribed by corporate laws and corporate internal rules.⁴

We talked briefly about incentives, mandates and regulations to limit risk takings, leverage and expand and elaborate corporate disclosure.

To expand here are some of the control measures that according to analysts may constitute meaningful reforms to the corporate governance structure:

Find the ideal model for financial institutions or “the perfect bank” and the mechanisms that will realize such a goal. Corporate governance must be redefined to find ideal balance between the forces of governance or the “governing mix”, as would like to call it. In the wake of the financial crisis and our review of literature, it is safe now to assert that all four measures of corporate governance namely stakeholder governance, market governance, regulatory governance and shareholder (internal governance).

Re- align the interests of shareholders, management and other stakeholders. This can be done in two ways. Either through mandates or rules generated from policies that set certain standardized volume of disclosure and a ceiling on risks being taken, or through providing incentives for sound management and contributions to stability. Regulators can incentivize managements of financial institutions to play closer attention to the market and use market measures to determine their incentives⁵. For example, the current practice

¹Sun and Stewart et.al , (2012)

²Mehran and Mollineaux , (2012)

³Sun and Stewart et.al, (2012)

⁴Sun and Stewart et. al., (2012)

⁵Mehran and Mollineaux, (2012)

of allowing top executives six figure bonuses because they yielded high returns must be adjusted to the state of the economy, rather than simply the nominal values of the return. Or as Mehran and Mollineaux suggest, their bonuses could be tied to “a proxy for bank credit quality or decrease in CDS spread”.

“As profit –based bonuses are currently widespread within the financial industry, they are undesirable from the stance of both risk and return.” Under this policy, cash leaves the firm without any mechanism to safeguard against profits made by piling on risk or looting the overall value of the firm.”¹

In financial institutions, there is usually a tradeoff between innovation and stability and given that innovation is not always tangible, the CDS approach to setting compensation levels will likely create a stabilizer if bonuses run in proportion to the credit quality of financial institutions.

Finally, regulators should take restrictive measures on business activities and asset and loan growths. In case of poorly performing banks (in terms of the real value of performance) they could demand removal of management or even directors. Finally, when tangible equity to asset ratio falls below 2%, regulators must take steps to close the institutions

6. Boards and Financial Institutions

6.1 The Board, Senior Management and the Oversight Functions

6.1.1 The board of directors

The Structure of a board needs a clear understanding of the respective roles of the board members and professional relationship to ensure good corporate governance practice. The relationships of the board with shareholders should comply by honesty; their interactions with workforces should be characterized by equality and fair-mindedness; their relationships with the communities in which they operate should maintain welfare; and their relationships with government should be characterized by a commitment to compliance.

Board act as representative of the stockholders. The most important responsibilities of a board is to appoint and oversee a well-qualified and ethical CEO (Chief Executive Officer). With the help of senior management, board runs the corporation on a daily basis, evaluate management's performance with faithfulness to corporate standards. Effective corporate directors are diligent monitors, but not managers, of business operations.

Effective composition of a board is very essential because the overall corporation's success is likely to depend on this. The composition should be designed to optimize the alignment thereof with the needs created by the various businesses and markets in which the company does business. To form the board effectively, approximately one fourth of its members of a board have been chosen by the votes of the shareholders at the General Shareholders Meeting each year. Effective board facilitates competitive advantages and holds the company during various stages of its life.

The composition of a board should maintain some criteria that establish long term neutrality in a company. There should involvement of independent directors (77% of the non-executive directors are independent); who have extensive knowledge, skills and experience of related fields. Another requirement to compose a board is 36% directors needed to be female to balance diversity. To overall responsibilities should be predetermined in order to effective operation of the Board of Directors.

6.1.2 Senior Management

It is the responsibility of the senior management under the CEO's direction, to operate the corporation in an effective and ethical manner. The CEO should be aware of the major risks and issues that the corporation faces and is responsible for supervising the corporation's financial reporting processes. For example, the CEO is responsible for providing stockholders and others with information that the CEO believes is important to understanding the corporation's business. Of course, the CEO necessarily relies on the expert advice of others on technical questions and legal requirements.

As part of its operational responsibility, senior management is charged with:

Operating the corporation: The CEO and senior management run the corporation's day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation's strategic objectives within the annual operating plans and budgets reviewed by the board.

Strategic planning: The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is completed; and recommend and carry out changes to the plans as necessary.

Annual operating plans and budgets: With the corporation's overall strategic plans in mind, senior management develops annual operating plans and annual budgets for the corporation, and the CEO presents those plans and budgets to the board. Once board review is completed, the management team implements the annual operating plans and budgets.

Selecting qualified management and establishing an effective organizational structure: Senior

¹Mehran and Millineaux, (2012)

management is responsible for selecting qualified management and for implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.

Identifying and managing risks: Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.

Good financial reporting: Senior management is responsible for the integrity of the corporation's financial reporting system. It is senior management's responsibility to put in place and supervise the operation of systems that allow the corporation to produce financial statements that fairly present the corporation's financial condition and thus permit investors to understand the business and financial soundness and risks of the corporation.

The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its stockholders. In carrying out this function, The Business Roundtable believes that corporations should have:

- I. The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.
- II. Senior management, and particularly the CEO, should set a "tone at the top" that establishes a culture of legal compliance and integrity communicated to personnel at all levels of the corporation.
- III. A corporation should have an effective system of internal controls providing reasonable assurance that the corporation's books and records are accurate, that its assets are safeguarded and that it complies with applicable laws. The internal controls system should be periodically evaluated and updated so that it continues to be effective in a changing environment.
- IV. A corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

6.1.3 Oversight functions

The main function of the board and senior management of financial institutions is to provide the necessary framework and support, and is directly accountable for the institution's stability and its compliance with legislative regulations.

The board's primary responsibility is to provide "stewardship or goal setting and provide general oversight of the management and operations".¹

The senior management is responsible for implementing the decisions of the board and paying closer attention to the oversight of operations. The oversight of operations is most crucial in terms of internal governance and sometimes these functions may be delegated downwards by senior managers.

The way the senior management of financial institutions is designed will vary from one institution to the other. Senior Management is composed of the Chief Executive Officer (CEO) and individuals who are directly accountable to the CEO. Besides those who report directly to the CEO, senior management may also include the executives responsible for the oversight functions, such as the "Chief Financial Officer (CFO), Chief Risk Officer (CRO), Chief Compliance Officer (CCO), Chief Internal Auditor, and Chief Actuary (CA)".²

6.2 The Uniqueness of Financial Institutions

Financial Institutions such as banking companies pose unique corporate governance attention as they differ greatly with other types of firms in terms of broader extent of claimants on the banks assets and funds. A group of entrepreneurs or executives could set up a banking business by putting very little equity from their own pocket as the nature of business itself guarantees flow of enormous amount of funds in the form of deposits. The general approach to corporate governance argue in favor of the shareholders rights only, as Managers may not always work in the best interest of the shareholders but the Shareholders actually account for a very tiny portion of the bank's assets and funds. Rather maximum bit of banks' investments are financed by the depositors funds. As a result a broader view of corporate governance should be adopted In the case of banking institutions because of the peculiar contractual form of banking. Corporate governance mechanisms for banks protect depositors as well as shareholders.

Banks also have shareholders, directors and managers, with the same agency conflicts and costs. Two approaches to corporate governance related laws & regulations:

- Monitor banks through laws and regulations, based on international best practices (Basel I & II).
- Empower banks through information and best practices through a code based on the OECD Principles and Basel Committee Guidelines

¹OSFI, (2013)

²OSFI, (2013)

6.3 Board Responsibilities

The Board of a company generally manages and controls the business of the company. Board takes major decisions about operations and other policies which is delegates to the chief executive officer (CEO), and through him to other senior management who has the authority and responsibility for managing the daily concerns of the organization. Director's act as the representatives of business shareholders thus monitor top management activates. The major broad responsibilities can be summed up as follows:

- **Appoint CEO:** The assessment, selection and compensation of a well-qualified, experienced and ethical Chief Executive Officer is one of the major concerns of the board. Top management team is the pillar of the organization hence the board also appoints or approves other members of the senior management team.
- **Share expertise:** Generally a wide range of experience, skills and judgment is provided by the directors. In addition if different directors of a board are professional in different sectors, is more preferable by an organization. They should represent the corporation as a whole not the interests of particular constituencies.
- **Directing stockholder:** The board is accountable for answering or directing to the council and the shareholders' meeting.
- **Inspection:** Board or committee proceedings are always inspected and recorded by the Directors. They Practice the duties of care, proficiency, reliability and diligence which is projected and confirm proper understanding of the operations, business and the supervisory requirement.
- **Opinion sharing:** Directors attend AGMs (Annual General Meetings) to share the opinions of shareholders.
- **Formation and monitoring Audit Committee:** Directors of Financial Institutions must form an Audit Committee, which supervises the internal and external audit practice of the organization.
- **Other issues:** In addition, Board also executes corporate strategies, risk control procedure, assessment and advancement of annual budget and business plans. Directors are commuted to control the fulfillment of strategies, the achievement of planned outcomes, determination of their remuneration, scheduling their work and their replacement.

6.4 Board Effectiveness

Board of directors is the middle men between the shareholders and the corporation. The primary objective of directors is to protect the funds and rights provided by the shareholders and initiating strategies to maximize the profit thus it will be possible to provide them more dividends to and encouraged them for further investment in the organization. To make it happen, effective directors maintain an attitude of constructive skepticism, which involves verification, collaboration, confirmation of various issues and investigation, exploration, provide solution of the issues that is harmful for the corporation. Commonly directors considered as a symbol of reliability that shows commitment towards corporation, its business strategies and long-term stockholder value.

The directors ensure minimization of the overall risk of the organization and compare the firm's risk with their effectiveness. Their perception is, as they minimize risk their effectiveness will increase. The board confirm that the internal risk procedures are efficient and that the risk management and internal control have a balance between currently performing and expected in a year. Various variables such as board size and structure, effectiveness of the independent directors, performance evaluation of the CEO by the board and many others are used to measure the board effectiveness.

6.5 Board Skills and Competencies

A Corporation always prefers to form the board with the most skillful, experience and adroit professionals. Board usually prefers directors with related business and industry experience which is beneficial to the board as a whole. Directors with such backgrounds can provide their expertise to reduce the risk level, increase competitive advantages and understanding of the various situations that facing the business. Organization goes through different stages in accordance with the time thus need for particular backgrounds and experiences may change over time too. The board should compose of the fusion of abilities and knowledge to evaluate each stage in the life of the corporation. That also confirms that the board has the necessary tools to perform its oversight function effectively.

There are no rigid rules related to board of director's skills and competences. But it is not recommended to select one and the same board member for more than four successive terms. Still if such election is admitted, it is also recommended to change the sector of work of the relevant Board member at the Issuer.

6.6 Board Independence

Board independence depends on various factors. One of the factors is director's distinct relationships with personal, employees and business. But the key factor that affects the most is board's overall attitude toward top management team. Moreover there should be a separate criteria of independent directors.

“The board of a corporation should have a substantial degree of independence from management. An

independent director should be free of any relationship with the corporation or its management that may impair, or appear to impair, the director's ability to make independent judgments.”¹

The ultimate goal of the board's oversight function is to make sure independent and practical judgment and decision. The board should be formed in such a way that this principle should reflect in its composition.

The overall responsibilities and authorities of a board should be formally prepared and documented. This information's commonly published in various websites and annual reports that shareholders and potential investors can evaluate the strength and power of the board.

6.7 Committees

A sector in a corporation which is complicated by nature or it is likely to arise conflicts or possibility of corruptions is regulated and inspected by committees which are subsets of a board. Board composes the committees generally with non-executive directors. Committees in which conflicts of interest are more likely to occur is administered by a member of the board. Based on the type of the organization there might have various committees such as Audit Committee, Nomination Committee, Corporate Governance Committee etc. The goal of a committee should serve the potential objectivity and to ensure fairness of various sectors. ²

6.8 Audit Committee

Financial Institutions must have an Audit Committee, which supervises the internal and external audit process. The composition of the audit committee requires members who have expertise and extensive knowledge about the financial and banking sectors to carry out their duties properly. The primary function of audit committee is to prepare and verify the financial statements of corporations. If there is no risk management committee then audit committee also performs risk management of the corporation. The chairman of the audit committee must be a financial specialist and a non-executive director. It is also preferable that the chairmen are not a member, director or officer of any Stock Exchange. Boards of Financial Institutions should have an Asset-Liability Committee (ALCO) which examines the overall position and risk level of the asset and liabilities held by the Financial Institutions.

7. Risk and Risk Management

Risk is a generic element of investment or finance, for that matter. Every investment that individuals, private firms, corporations or financial enterprises make involves risk and as we know the risk increases in proportion to the anticipated return. As we have already talked about the Anglo – American model of corporate governance makes it almost illegal to regulate financial institutions and the market approach to governance leaves the financial decisions at the hands of internal players and at the mercy of the invisible hand. Meaning , the management of the firm can , if they will , take unlimited risk , hoping for infinite return , which can not only put the corporation stake but the creditors and the investors whose money the financial institution is using . This can lead to a bubble which eventually crashes, drowning a whole economy in financial chaos. The returns from these risky investments are not adjusted for the risk or the state of the economy and the nominal value of the returns earn the top management huge amounts of bonuses.

Hence, to prevent this corporate greed from taking a toll on the economy risk management is required, in the best interest of shareholders and other stakeholders. There must external regulators who have the control required to limit the risk takings of a financial firm, or contribute to the “risk management” of the firm. This is also the responsibility of the board to see to it that excessive and unreasonable risks are not being taken.

“Risk management failures at major corporations have captured the headlines for many years, primarily in the financial sector, but in other sectors as well, and have not always been the result of shortcomings in financial risk-taking. Environmental catastrophes such as Deep Water Horizon, Fukushima ,Bhopal and Seveso, as well as accounting fraud such as Olympus, Enron, WorldCom, Satyam, Parmalat, or foreign bribery such as Siemens cases, to name just a few from the non-financial sector. Often these failures were facilitated by corporate governance failures, where boards did not fully appreciate the risks that the companies were taking or deficient risk management systems.”³

- According to the OECD guidelines, it is the responsibility of the board is to reviewing and guiding the risk policies of the firm and seeing to it that their policies are in compliance with the law, including the determination of the type and level of risks the firm can take.

Furthermore, the liabilities arising from the risks must be reported duly in the financial reports. In the wake of the financial crisis, many firms, especially financial institutions have moved large amounts of liabilities off their balance sheets to investment assets, involving incredibly high amounts of risk. It is the board's

¹Corporate Governance System.(2015)

²The Code of Corporate Governance for Bangladesh;(March 2004)

³Risk Management and Corporate Governance, (2014)

responsibility that prudent disclosure of information, related to risk is reported in the interest of stakeholders. Under the heading, “Risk transparency and Disclosure in the SOE Guidelines”, the OECD writes, “Severe difficulties arise when SOE (State Owned Enterprises) undertake ambitious strategies without clearly identifying, assessing or duly reporting on the related risks. Disclosure of material risk factors is particularly important when SOE’s operate in a newly de-regulated environment “.¹

In many cases, the risks undertaken by a corporation is not a part of their strategic management and the risk manager is isolated from the strategic managers and in most of these cases the boards were unaware of the risks being undertaken .Proper implementation of risk and risk management requires an enterprise-wide approach instead of treating risk management as an isolated unit of business. The aim is not to eliminate risk, which is a vital component of entrepreneurship and business, but to ensure that risk is understood, communicated and managed in line with the organization’s overall strategy.

The OECD suggests that to help the board in its pursuit of risk management that risk management and control functions be independent of the profit-making units of the firm and the “chief risk officer” should report directly to the board members. In the light of our research on corporate governance, the financial crisis and its elements, we believe risk management can be made more effective in the following ways.

- Allow independent external consultants to assess the risk undertakings of corporations and let there be an authorization body to sanction the level and type of risks being undertaken.
- Having an independent internal functional body to do risk auditing who is directly answerable to the board.
- Base the compensation of senior management not only on returns but the prudence of the risk that is being undertaken.
- Make it a standardized best practice for all corporations, especially financial corporations to annually report on the risk undertakings of the firm, separately from other financial statements. It can be called “Statement of Risk analysis”, which adjusts the profit earned to the level of risk being taken.
- Public disclosure of risk analysis.
- Have a legislative body, including analysts, customer union chiefs and treasure officials to oversee the overall risk management in the economy.

A list of sound risk governance practices that would help firms continue to improve their risk governance and national authorities to assess its effectiveness are:

1. National authorities should strengthen their regulatory and supervisory guidance for financial institutions and devote adequate resources to assess the effectiveness of risk governance frameworks.
2. Standard setting bodies should review their principles for governance, taking into consideration the sound risk governance practices set out in the report.
3. The FSB should explore ways to formally assess risk culture at financial institutions.
4. The FSB should provide general guidance on the key elements that should be included in risk appetite frameworks and establish a common nomenclature for terms used in risk appetite statements.

8. Market Discipline

8.1 Shareholders Rights and Disclosures Information:

Shareholders have some perpetual rights so prime task of directors and management is to serve those rights. Shareholders rights includes available information of corporation financial and economic position, risk concerns and upcoming opportunities or threats that might affect their investment within the corporation. Moreover they have rights to attend the annual general meeting and share their views and provide opinion. This facilitates a justified determination of the price of financial instruments such as share; bonds etc. in public circulation as well as maximize the trust in finance and capital markets. “Directors should be incentivized to focus on long-term stockholder value.”²

In the other hand; Disclosure of information is closely connected with investor relations which can be defined as the process of developing Issuer’s relations with its potential and existing investors and other parties interested in the business of the Issuer.

8.2 Public Disclosures and Transparencies

Corporation should provide clear and transparent information declaring financial, economic and internal management condition. Based on these information shareholders, depositors and potential investors calculate risk and return and invest in the firm. So its significance is undeniable. The objective of the corporation should be disclose information of considering public convenience or make it as available as possible. In the other hand based on this information investors invest in a firm, so the market price should match with their expected calculations. The information disclosed shall be precisely checked, defined and prepared in accordance with

¹OECD,(2014)

²Principles of Corporate Governance,(2009)

International standards.

“Public disclosure in an important element of governance in the corporate world because it builds trust, helps bring new investors and ensures smooth functioning of the capital markets and excels the company growth.”¹

9 Assumptions

Based on our study on the corporate governance we have developed a hypothesis and this hypothesis is based on few more objectives/criteria.

Hypothesis 1: Corporate governance is positively related with financial institutions efficiency.

We will examine various institutions based on this hypothesis. It could be ‘1’ means it is positively related with financial institutions efficiency or it might be ‘0’ means it is negatively or not related with financial institutions efficiency. Determination of this thesis might require some criteria and we identified some of them. This Criteria’s or objectives are also expected, assumed and findings from other research and are shown below

- Board structure positively related with bank efficiency
- Board size is negatively related to bank efficiency²
- Board independence is positively related to bank efficiency³
- Audit committee’s size and authority is positively related to bank efficiency⁴
- Fairness of financial statements are positively affected with the bank efficiency
- Number of board meetings are positively related with bank efficiency
- Relationship between board and management is positively related with bank efficiency
- Proportion of independent directors (more than 1:10) to board are negatively related with bank efficiency

9. Prior Analysis and Correlation

Our research area is the private commercial banks of Bangladesh. We find out some findings and important facts about financial institutions of Bangladesh which we will help relate to our overall findings and recommendations. Code of corporate governance was established in our country at 2006. Due to the financial crisis of some of the business magnets such as Cadbury, various investigations make a slimmer conclusion that enormous corruption and self-interested management team was responsible for this massive fall down. As a recommendation the first priority was given to implement efficient practice of corporate finance from different professionals. By implementing such effective steps those companies eventually recover their loss and again back to their full operations.

The code of corporate governance used in Bangladesh is mainly a rule based approach. Under this system, Directors mainly focus to fulfill the requirements in a form which is prepared by the SEC (security stock exchange). This approach is also known as ‘box ticking’ approach by which investors and shareholder can understand current corporate governance practice in a company. This is mandatory to include the box ticking guidelines to appear in the annual reports. Investors always wanted to invest where they can evaluate the good corporate governance practice. The guidelines are the timely attempt by the policy makers to improve the general quality of corporate governance practices in Bangladesh. In a developing market like Bangladesh, SEC provides many conditions that include audit committees, independent directors in the board and so on.

This rule is prepared to increase the level of efficiency, quality and competitiveness throughout the national economy. These guidelines used as measurement the process towards the best practice, criteria of a sound capital market.

The biggest problem with such approach is that it would encourage directors to concentrate on form rather than on exercising their discretion on what corporate governance practices are best suited for their companies. Self-centered directors and management team may be involved in unethical practices by arranging matters in such a way so that a complete compliance with rules can be arranged without maintaining substance. Or simply they are not that much concerned about the maintenance of good governance rather focus to earn more profit and revenue. This approach simply not suggests elimination of entire deep rooted governance problem.

¹Principles of Corporate Governance and Recommendations on Their Implementation,(2010)

²Prakash, Poudel & Hovey,(2013)

³Prakash, Poudel & Hovey,(2013)

⁴Prakash, Poudel & Hovey,(2013)

10. Findings

Table 1: Scoring Banking Financial Institutions of Bangladesh using 17 variables (See appendix-survey basis for score breakdown).

Financial Institutions	V1	V2	V3	V4	V5	V6	V7	V8	V9	V10	V11	V12	V13	V14	V15	V16	V17	Score	Mean
1. AB Bank LTD	1	1	1	1	1	1	1	1	1	1	0	1	1	1	1	1	1	16	0.94
Actual quantity/reason for scoring	14	3	1/5			30		6			6								
2. Al-Arafah Islamic Bank LTD	0	0	0	1	1	0	1	1	1	1	0	1	1	1	1	1	1	13	0.78
Actual quantity/reason for scoring	23	2	1/12			18		5			5								
3. Islami Bank Bangladesh LTD	1	1	1	1	1	0	1	1	1	1	1	1	1	1	1	1	1	16	0.94
Actual quantity/reason for scoring	15	3	1/5			19		4			4								
4. NCC Bank LTD	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	17	1
Actual quantity/reason for scoring	15	2	1/7			23		5			5								
5. Basic Bank LTD	1	0	0	1	1	0	1	1		1	1	1	1	1	1	0	1	13	0.76
Actual quantity/reason for scoring	7	0	0			9		3			3								
6. United Commercial Bank LTD	1	1	1	1	1	0	1	1	1	1	1	1	1	1	1	1	1	16	0.94
Actual quantity/reason for scoring	18	3	1/6			16		4			4								
7. BRAC Bank LTD	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	17	1
Actual quantity/reason for scoring	10	2	1/5			26		4			4								
8. Bangladesh Commercial Bank LTD	1	0	0	1	1	1	1	1	1	1	1	1	1	1	1	0	1	14	0.82
Actual quantity/reason for scoring	11	0	0			21		5			5								
9. Commercial Bank of Ceylon PLC	1	1	1	1	1	0	1	1	1	1	1	1	1	1	1	1	1	16	0.94
Actual quantity/reason for scoring	9	4	1/2			12		5			5								
10. Dutch-Bangla Bank LTD	1	1	1	1	1	1	1	0	1	1	1	0	1	1	1	1	1	15	0.89
Actual quantity/reason for scoring	9	1	1/9			22		4			4								
11. City Bank LTD	1	0	0	1	1	1	1	1	1	1	1	1	1	1	1	0	1	14	0.82
Actual quantity/reason for scoring	12	1	1/12			27		5			5								
12. Dhaka Bank LTD	1	1	1	1	1	0	1	1	1	1	1	1	1	1	1	1	1	16	0.94
Actual quantity/reason for scoring	20	2	1/10			17		6			6								
13. Jamuna Bank LTD	1	0	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1	15	0.89
Actual quantity/reason for scoring	14	1	1/14			30		5			5								
14. Bank Asia LTD	1	0	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1	15	0.89
Actual quantity/reason for scoring	11	1	1/11			23		5			5								
15. Prime Bank LTD	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	17	1
Actual quantity/reason for scoring	19	3	1/6			34		5			5								
16. IFIC Bank LTD	1	1	1	1	1	0	1	1	1	1	1	1	1	1	1	1	1	16	0.94
Actual quantity/reason for scoring	14	3	1/5			17		4			4								
17. Premier Bank LTD	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	17	1
Actual quantity/reason for scoring	18	3	1/6			27		5			5								
18. One Bank LTD	1	1	1	1	1	0	1	0	1	1	1	0	1	1	1	1	1	14	0.82
Actual quantity/reason for scoring	20	3	1/6			16	1	2			2								
Standard Deviation (SD)																			0.07762

Table 2: Disclosed percentage, mean, SD, minimum and maximum of variables of 18 banks.

Variables	Observations	Score	Disclosed Information (percentage)	Mean	Median	Mode	Minimum	Maximum
1. Board's size	18	17	94%	0.94	1	1	9	20
2. Independent director	18	12	67%	0.67	1	1	0	4
3. Appointment of Independent Director by elected Directors	18	12	67%	0.67	1	1	1:2	1:12
4. Fairness of Financial Statements	18	-	100%	1	1	1	-	-
5. Maintenance of proper books of account	18	-	100%	1	1	1	-	-
6. Number of board meeting	18	10	55%	0.55	1	1	12	34
7. Compliance with International Accounting Standards	18	-	100%	1	1	1	-	-
8. Company shall have an Audit Committee as sub-committee of the Board of Directors	18	16	89%	0.89	1	1	2	6
9. External statutory auditors	18	-	100%	1	1	1	-	-
10. Appointment of CFO, Company Secretary & Head of Internal Audit and their clearly defined rules and responsibilities	18	-	100%	1	1	1	-	-
11. Attendance of CFO & Company Secretary in the Board of Directors meeting	18	-	89%	0.89	1	1	-	-
12. Composition of Audit Committee	18	2	89%	0.89	1	1	2	6
13. Chairman of the Audit Committee	18	-	100%	1	1	1	-	-
14. Management & Audit committee reporting the activities to the Board of Directors	18	-	100%	1	1	1	-	-
15. Reporting the activities to the Shareholders and General Investors	18	-	100%	1	1	1	-	-
16. Independent Director is not a member, director or officer of any Stock Exchange	18	-	83%	0.83	1	1	-	-
17. Conducting internal Audit	18	-	100%	1	1	1	-	-

10.1 Findings from Table-1 and Table-2

Total 18 commercial banks of Bangladesh have been taken as sample size. This Financial Institutions have been taken randomly and they are enlisted with the Security Exchange Commission (SEC). Total seventeen variables

have been identified on the basis of Security Exchange Commission corporate governance guidelines.

Table 1 shows the bank by bank survey results with respect to seventeen variables have been identified on the basis of Security Exchange Commission corporate governance guidelines. It also shows mean value of individual banks and standard deviation of overall banks.

Table 2 is based on the results of table 1 which categorizes and analyses the seventeen variables. If we consider, score seventeen out of seventeen then it will a full disclosure of information from the firm. Table 2 also shows the minimum and maximum number of individual variables from the survey result with their mean or average value.

Financial score of banking financial Institutions shows the overall score is good but some institutions does not disclosed certain information. Form our survey, we have come to know that

- All the banks disclose 100% information in respect to Fairness of Financial Statements; Maintenance of proper books of account; Compliance of accounting policies and estimates; External statutory auditors; Appointment of CFO, Company Secretary & Head of Internal Audit and their clearly defined rules and responsibilities; Chairman of the Audit Committee; Management & Audit committee reporting the activities to the Board of Directors; Reporting the activities to the Shareholders and General Investors and Conducting internal Audit.
- Some factors related to corporate governance are accurately and uniformly maintain by the Financial Institutions. This factors are positively related with corporate governance. From table 2, the lowest percentage of disclosed information (67%) is identified as Independent director and Appointment of Independent Director by elected Directors.
- Most of the Financial Institutions does not appoint and maintain the right number of independent directors. We can relate this result to our assumption and others findings, "Board independence are positively related with bank efficiency."¹
- From table 2, Board size (94%) and Number of board meetings (78%) can be identified. We also can relate to our earlier assumptions that other findings, "Board size is negatively related and number of board meeting is positively related with the board efficiency."²
- Form table 2, Audit Committee as sub-committee of the Board of Directors; Attendance of CFO & Company Secretary in the Board of Directors meeting; Composition of Audit Committee have 89% disclosed information among the financial institutions. "Audit committee's size; Audit committee's independence and Audit committee's diligence is positively related to bank efficiency."³

From table 1, it is clear that within the observed financial institutions the most prominent banks are Prime Bank LTD, BRAC Bank LTD, Premier Bank LTD and NCC Bank LTD which reveal "1" mean. This banks also disclose 100% information. That indicates they follow almost every instruction set by international and national (SEC) regulatory body to create an effective corporate governance.

10.1 Findings from Survey

A set of 23 questions related to corporate governance has been prepared for internal higher level management. The main goal to do this questionnaire survey is to check and relate the finding effectiveness with our other observations.

The board size of Trust Bank LTD is 10 which includes 3 independent directors. It is considered good practice if a board size is in between 5-20 and proportion of independent director to board size is at least one tenth, independent directors should appointed by elected directors. Trust Bank LTD have full filled all those criteria. The board includes sub committees such as audit committee, compensation committee and audit functions are maintain by the preset and transparent rules compliance with international accounting standards. Moreover there are no foreign directors in the board and independent directors are actively participating the board discussions which positively express good governance in this bank.

Survey results also shows Trust Bank LTD perform 10-15 board meetings in a year and attendance of board members are very regular. Annual general meetings held as per schedule, More than 500 Shareholders are averagely attend every meetings and it last for 3 hours. Shareholders also contribute their views in this meetings.

Each year Trust Bank LTD publish their annual report as well as they also discloses semi-annual, quarterly financial reports consistently. The bank perform both internal and external audit in accordance with International standers and Securities exchange commission (SEC) of Bangladesh. For external audit they

¹Prakash, Poudel & Hovey ,(2013)

²Prakash, Poudel & Hovey,(2013)

³Prakash, Poudel & Hovey ,(2013)

rely/hire other audit firms and internal audit is done by the internal accountants and check by the audit committee.

The Trust Band LTD has a clear rules and regulations for appointing high level management .Ownership is fairly distributed among no-controlling shareholders. Board inspect the management activities but does not control the management.

Except the number of board meetings which prefer at least 20 meetings in a year, Trust Bank LTD follow all other corporate governance components instructed by SEC.

11. Recommendations

- Board structure should be efficient that could add more value to both corporation and shareholders. More than efficient could impact on decision making and overall performance of directors. Less than efficient could directly impact on direction and control over management and stockholders.
- Standard authority and accountability should ensure to the Independent directors. Number of Independent directors should match the efficient level. Less than efficient can leads a corporation towards corruption and unethical practices.
- Rights of the shareholders should be maintaining in an attentive manner. Disclosures should be made timely and it should be transparent. In addition annual reports should be disclosed on online and if possible it should publish in English and native language.
- Both board and management should be focus on understanding and managing risks. Risks cannot be fully recovered but the minimization should be the target. Board should ensure strong control of environment and process by implementing efficient risk management committee.
- Strengthen transparency and discloses of information needed by the financial institutions. Banks should verify the audit done by internal and external parties. Financial statements should prepare with accordance with the IASB and IAS.
- Banks should maintain Government and regulators (SEC and various ministries) requirements. In addition those rules are updating overtime. So Financial institutions also needed to update with new regulations.
- Banks should identify and explore the possible improvements and provides priority based suggestions to improve Corporate Governance practices.
- Develop and publish a Code of Corporate Social and Environmental responsibilities.

12. Conclusion

Corporate governance is the total sum of internal management of a company that maintain the relationship between investors and managers to serve the long term benefits of shareholders. We can also define this as a mixture of ethical practices that made a firm to compete in various situations such as financial crisis. From our study we come to know that, Different categories of firms are very from each and other by their nature thus implementation of corporate governance is also varies. In this report, we observe the corporate governance features of financial institutions of Bangladesh, gone through the pre research and findings and conduct a recent research on corporate governance in financial institutions. The core results of our observations are the implementation and maintenance of corporate governance practices in our financial institutions significantly increases then before and organizations are committed to improve this practice further. We have notice that corporate governance practice have found a new direction after introduction of code of corporate governance of Bangladesh. To collect in-depth information we have discussed with a top manager of a prominent bank. By this we come to know that banks are highly aware of their unique formation and high market competitions. Recently one of their major focuses is on implementing good corporate governance practice among the firms.

On the other side, some institutions are still practicing traditional rules and regulations. They are more focus on current wellbeing that thinking long run. All financial institutions should improve their commitment and perception towards overall good Corporate Governance. They should not consider it as forced rules and regulation from national and international bodies rather they consider this as a fundamental tool for internal control and efficiency. Many professionals agreed upon the fundamental cause for financial crisis situation is inefficient corporate governance practice. So our financial institutions should consider this major issues to remain in operation.

However we believe that our report will give a real image of this scenario. We tried to find the problems, compare it with other companies and showed the reason for this error. Moreover we try to find the possible solution for overcoming this situation.

We also believe upon our secondary research that the Anglo American structure of corporate governance, which exclusively preserves market orientation and ignores external regulatory control, is detrimental to society as a whole. The perfect financial institution must have a balance between innovation and stability. It must deal in instruments that are innovative but involves reasonable risks, the consensus of

stakeholders other than shareholders and must have an incentive structure based on the real value of returns which is adjusted to risk and economy.

We believe that our report will give a real image of this scenario. We tried to find the problems, compare it with other companies and showed the reason for this error. Moreover we try to find the possible solution for overcoming all adverse situations. We hope that our research will open ways for further study on the topic until we discover the ideal framework of corporate governance which is beneficial to all concerned.

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14. Appendix

13.1 Scoring-Survey Basis

Variable #1(V1) =Board's size

- Should not be less than 5 and more than 20 (1)
- If less than 5 and more than 15 (0)

Variable #2(V2) =Independent director

- At least 1/10th i.e. minimum one (1)
- If no independent director (0)

Variable #3(V3) =Appointment of Independent Director by elected Directors

- If yes (1)
- If no (0)

Variable #4(V4) =Fairness of Financial Statements

- Fair and transparent (1)
- If not (0)

Variable #5(V5) =Maintenance of proper books of account

- If yes (1)
- If no (0)

Variable #6(V6) =Number of board meeting

- 20 and more (1)
- If not (0)

Variable #7(V7) =Compliance with International Accounting Standards

- Compliance with IASB & IAS (1)
- If not Compliance with IASB & IAS (0)

Variable #8(V8) =Company shall have an Audit Committee as sub-committee of the Board of Directors

- Must have an Audit Committee and it is sub-committee (1)
- If not (0)

Variable #9(V9) =External statutory auditors

- If yes (1)
- If no (2)

Variable #10(V10) =Appointment of CFO, Company Secretary & Head of Internal Audit and their clearly defined rules and responsibilities

- If yes (1)
- If No (0)

Variable #11(V11) =Attendance of CFO & Company Secretary in the Board of Directors meeting

- If yes (1)
- If no (0)

Variable #12(V12) =Composition of Audit Committee

- Should be composed of at least 3 members (1)
- If not (0)

Variable #13(V13) =Chairman of the Audit Committee

- The Board of Directors shall select one member of the Audit Committee to be Chairman of the Audit

Committee, who shall be an independent director (1)

- If not (0)

Variable #14(V14) =Management & Audit committee reporting the activities to the Board of Directors

- If yes(1)
- If no(0)

Variable #15(V15) =Reporting the activities to the Shareholders and General Investors

- If yes (1)
- If no (0)

Variable #16(V16) =Independent Director is not a member, director or officer of any Stock Exchange

- If yes (1)
- If no (0)

Variable #17(V17) = Conducting internal Audit

- If yes (1)
- If no (0)

13.2 Questionnaire Survey on Corporate Governance Practices at Financial Institutions

General Information on the Company/Institution and Respondent

1. Respondent's Name: Wasef Nowsher
2. Sex: Male
3. Age: 39
4. Position: FAVP
5. Company Name: **Trust Bank LTD**

1. How do you describe the ownership and control structure of the company?

1. The largest shareholder has a substantial voting right and effectively controls the Company.
2. Two or more large shareholders collectively control the company
3. Ownership is fairly disseminated with no controlling shareholder, and shareholder does not directly control the management
4. Others (Please Explain:

Answer: 3

2. Is the company stand-alone company or a subsidiary of a business group or holding company?

1. Stand-alone company
2. Subsidiary of a family based business group.
3. Subsidiary of a business group not control by families.
4. Others (Please Explain:

Answer: 1, 4(A concern of Army Welfare Trust)

Shareholder Rights and Disclosure of Information:

3. How easy is it for your shareholders to participate in voting at the shareholders meeting? [May be more than One Answers]

1. Is voting by mail allowed?
2. Can anybody serve as a proxy?
3. Presence Requires
4. Others [Explain.....

Answer: 2

Express the extent to which you agree or disagree on the given statement by choosing (circle) one of the following:

5= strongly agree

4=Agree

3=No opinion

2=Disagree

1= strongly disagree

4. Shareholders are provided with adequate information on the agenda items of the Shareholders' meeting ... [(5), (4), (3), (2),(1)]

Answer: 5

5. Adequate time is given for asking questions and placing issues at the shareholders' meeting...[(5), (4), (3), (2), (1)]

Answer: 5

6. Are director candidates disclosed before the shareholders meeting?

1=Yes

2= No

Answer: 1

Information about the latest annual shareholders' meeting

7. How long did the meeting last?

1. Less than 30 minutes
2. (30-60 minutes)
3. (2-3 hours)
4. Over 3 hours

Answer: 3

8. How many shareholders attended the meeting? (.....)

Answer: 18

Disclosure and Transparency

9. Does your company disclose semi-annual reports?

1. Yes
2. No

Answer: 1

10. Does your company disclose quarterly financial statements?

1. Yes
2. No

Answer: 1

11. Does your company have a web-site? Is it also in English?

1. Yes
2. No

Answer: 1

12. Available and very informative both in local language and English:

1. Yes
2. No

Answer: 2

Effectiveness of the Board of Directors

13. How many directors does your (supervisory) board have in total? ----- [10]

14. How many independent directors does your board have? ----- [03]

15. Are there any foreign nationals on your board?

1. Yes
2. No

Answer: 2

16. Independent directors participating actively in board discussions:

1. Often
2. Sometimes
3. Rarely
4. Never

Answer: 1

Functions of the Board and Board Committees

17. Does your company have Audit Committee?

1. Yes
2. No
- 3=Other Explain.....

Answer: 1

18. Does your company have Nomination Committee?

- 1= Yes
- 2=No
- 3=Other Explain.....

Answer: 1

19. Are there written rules governing overall audit function in your company?

1. Yes
2. No

Answer: 1

20. Does your company select/recommend the external auditor and conduct a proper review of his work?

1. Yes
2. No

Answer: 1

21. Does it approve the appointment of the internal auditor and supervise him to routinely review risk exposure and accounting procedures?

1. Yes
2. No

Answer: 1

Board Meeting Frequency, Attendance, Etc.

22. How many board meetings were held last year?

- 1= (5-10 times)
- 2= (10-15 times)
- 3= (15-20 times)
- 4= (more than 20)

Answer: 2

23. What was the average attendance rate for board meetings?

1. (90-100%)
2. (80-90%)
3. (70-80%)
4. (60-70%)
5. (50-60%)

Answer: 1