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CHAPTER 3

NEW ORDER IN BANKING¹

Introduction

The smooth functioning of the economy requires a stable and efficient operation of the financial system. Poorly managed financial institutions burden the financial system. First, they adversely affect the rules and institutions of the public sector and, second, they grant loans to the wrong entities (denying loans to stable entities, which hampers the development of the economy) and excessively develop lending activity (which may lead to financial crises) [Kaufmann, 2002].

The financial system is as strong as its governance practices, the financial stability of its institutions and the effectiveness of its market infrastructure. The creation and application of good governance practices is the joint responsibility of market regulators and market participants [Das and Quintyn, 2002, p. 163]. However, there is no single effective remedy for all challenges to corporate governance in the financial sector. Empirical studies and theoretical considerations lead to the conclusion that in order to enhance corporate governance in banking it is necessary to ensure a stronger regulatory supervision, while also strengthening private oversight (market discipline): increasing transparency, the competitiveness of markets and the involvement of the owners [Litan et al., 2002, p. 13].

The recent crisis has exposed many areas of imperfection in the system of corporate governance in banks. This publication identifies the key areas of inefficiency of the system and attempts undertaken to reform it, and presents a discussion of the desired new foundations of the financial order.

1. Identification of the causes of corporate governance ineffectiveness and attempts to reform the system

There are many macro- and microeconomic causes of the 2008 collapse of the financial markets and the global economy. Of great importance was the excessive accumulation of risk in the financial system resulting from weaknesses in

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the corporate governance system in financial institutions, and especially in banks [European Parliament, 2011].

The financial crisis has exposed the weaknesses of corporate governance in banks. Some think that the crisis was brought about by inadequate implementation of corporate governance codes and principles; others argue that at least in part it was caused by a systemic failure of corporate governance (its institutional system is based on popular paradoxical assumptions, such as the primacy of shareholders, profit maximization, effective system of incentives, effective market for corporate control, etc.) [Sun et al., 2011, p. 5].

Moreover, it is pointed out that the fundamental problem of corporate governance in banks results from the lack of a direct relationship between the principles of corporate governance and financial stability. Indeed, the instruments of corporate governance contribute to the achievement of intermediate objectives at the level of individual institutions, but are not directly related to financial stability [Wymeersch, 2008]. There is no obligation imposed on banks, and they are not motivated in any other way, to care for financial stability or reduce systemic risk.

A detailed analysis of the causes of the crisis shows a number of corporate governance issues which require fundamental changes and tighter standards, namely [Kirkpatrick, 2009; Turner, 2009; Walker, 2009; Institute of International Finance, 2008; European Commission, 2010b; OECD, 2009; OECD, 2010; Marcinkowska, 2010]:

- The role, tasks and responsibilities of the board, as well as its size, organization and composition (qualifications of the members) and the functioning of this body and assessment of its work;
- Control of the risk incurred by the bank;
- Assessment of the management and systems of incentive compensation for its members;
- Transparency of the bank that would enable supervisory assessment of its operations (both through institutional supervision and private monitoring);
- The bank's ownership structure and the role of institutional investors.

These issues have been the subject of discussion of many decision-making bodies; some of them have already been taken into account in the new regulations and guidelines, while many more new regulations are still being developed.

As early as February 2009, a group of experts chaired by Jacques de Larosière recommended developing a European system of financial supervisors [The High-level Group of Financial Supervision in the EU, 2009]. In September 2009, a new supervisory structure was introduced (which started operations in January 2011): The European System of Financial Supervisors – ESFS, consisting

of bodies supervising banks (the European Banking Authority), insurance companies and pension funds (the European Insurance and Occupational Pensions Authority) and stock exchanges (the European Securities and Markets Authority) operating in the EU. The European Systemic Risk Board is another component of this structure.²

Among the new regulations one should first mention an EU initiative: in June 2010 the Green Paper on corporate governance in financial institutions and remuneration policies was published [European Commission, 2010c]. The document summarizes the areas of ineffectiveness and imperfections of corporate governance in banks (they are included in the list given above), points to the already undertaken preliminary legislative initiatives, and then presents, for consultation purposes, possible further solutions. The initiatives mainly concern the question of responsibility, independence and competence of the supervisory board. They strengthen the risk management function, enhance the status of the chief risk officer, introduce a new requirement for external auditors to alert the board of directors and bank supervisory authorities to any substantial risks they discover, enhance bank supervision, promote a greater involvement of the bank's shareholders and encourage them to exercise effective control. These initiatives also concern the issues of remuneration for the management and conflicts of interest. The Green Paper is accompanied by a working paper which shows best practices related to supervisory boards, risk management, owners, supervisors, and external auditors [European Commission, 2010a].

Prior to that, back in 2009, The Commission issued a Recommendation on remuneration policies in the financial sector [European Commission, 2009].³ The general requirement for banks was to adopt such remuneration policies that would promote correct and effective risk management, would not encourage excessive risk taking, and at the same time would support the implementation of business strategies and reduce conflicts of interest. In particular, the Recommendation defined guidelines on determining the variable component of remuneration.

Furthermore, the European Commission developed new regulations whose primary aim was to ensure more effective risk management in European credit institutions. These should help prevent individual credit institutions from taking

² More: http://ec.europa.eu/internal_market/finances/committees/index_en.htm.

³ In Poland, the recommendations were reflected in the resolution of the Polish Financial Supervision Authority (PFSA) No. 258/2011 dated 04.10.2011. The resolution replaces the PFSA resolution No. 383/2008 on detailed rules for the functioning of the risk management and internal control system and the specifics of estimating internal capital by banks and reviewing the process of assessing and maintaining internal equity, and the principles for determining the policy for variable components of remuneration of banking executives (the PFSA Official Journal, No. 11, pos. 42).

excessive risk, which could otherwise lead to excessive risk accumulation in the financial system. The new legal framework will have three operational objectives [European Parliament, 2011]:

- To increase the effectiveness of the board's control over risk;
- To improve the status of the risk management function;
- To ensure effective monitoring of risk management by supervisory bodies.

Among the global guidelines for banking reform, one should mention further initiatives of the Basel Committee on Banking Supervision (BCBS). First of all, attention should be paid to sectoral "good practices", which take into account the specific nature of banks. General rules aimed at improving corporate governance in banks were updated by the BCBS in October 2010, and the current version of the document sets out 14 principles in 6 areas [BCBS, 2010d]:

- Board practices;
- Senior management;
- Risk management and internal controls;
- Compensation;
- Complex or opaque corporate structures;
- Disclosure and transparency;

This document is further augmented with guidelines for the internal audit function in banks [BCBS, 2011b], which specify 20 principles concerning supervisory expectations in relation to the internal audit function, the relations of internal audit with the supervisory institution, and supervisory assessment of the internal audit function.

The issue of remuneration for members of the top management in banks was also taken into account in the Basel guidelines, as the document formulates compensation principles and standards for assessments methodology [BCBS, 2010c].

Criticism of the regulations on capital adequacy has led to the revision of the previous guidelines (Basel II); the BCBS has strengthened some of the requirements and introduced additional standards in this area (some of them are related to institutional and private supervision exercised over banks) [BCBS, 2010a; BCBS, 2010b].

The Basel guidelines are the basis for the development and revision of regulations in the European Union. In September 2011, the European Banking Authority published guidelines on internal governance⁴.

⁴ The EBA document repeals the earlier guidelines published by the CEBS (the EBA's predecessor) [CEBS, 2010; CEBS, 2009; CEBS, 2006] .

2. Ethical foundations for a new order of the financial market

Regardless of the identified causes of the global financial crisis, i.e., economic, regulatory, and political factors, it must be stressed that low moral standards and a departure from ethical principles in banking were the crucial causes of the development and spread of the crisis – “financial bankruptcy is accompanied by intellectual and moral bankruptcy” [Flejterski, 2010].

“Greed”, “avarice”, and “lust for profit”, which by the end of the twentieth century became the key business message (wrapped in the philosophy of generating shareholder value), have led to the erosion of moral values in the economy [Visser, 2010, p. 232].⁵ The obsession with financial performance and the dogma of higher profits and higher returns on capital corrupt managers, weaken the company, and consequently – the whole social fabric, degrading humanitarian values and leading to immorality and corruption [Dembiński, 2011, p. 147; Minzberg, 2004].⁶

Again, the issue of honesty becomes the key problem in the economy. A system of corporate governance should be founded on honesty, understood not only as legality (referring to a system of law which may demand good behaviours by penalizing bad ones), ethics (referring to agreed standards as to which attitudes are desirable and which are undesirable) and morality (referring to generally accepted social norms of what is desirable or undesirable, good or bad). Honesty must encompass at once legality, ethics and morality. M. Jensen has even added honesty to the set of major factors of production, highlighting its importance for increasing the efficiency of the organization [Cressy et al., 2010, pp. 117-120]. Ethics and morality can support the mechanisms of corporate governance and must become the foundation for systemic changes.

It should be stressed that ethical issues in the world of finance concern four levels [Gasparski et al., 2004, pp. 23-24]:

- Individual behaviour – the responsibility of specialists acting as representatives (agents), such as bankers, managers, etc.;
- Institutional behaviour – rules and standards set by financial organizations, stock exchanges, government regulatory institutions, etc.;

⁵ “The global financial crisis represents a multi-level failure of responsibility – from the individual and corporate level to the finance sector and entire capitalist system.” [Visser, 2010, p. 232]. The author describes “a culture of greed embedded in the DNA of the company and financial markets”, and proposes as a remedy a revived system of corporate social responsibility.

⁶ The authors criticize the current trends in management education and practice and shows the consequences: corruption of the educational process, corruption of managerial practice, corruption of established organizations, and corruption of social institutions.

- Corporate behaviour – people who are responsible for corporations (corporate executives) must act in the interest of the owners, who are not so much responsible for the social damage caused by their corporations (in the broader sense these issues are related to corporate governance);
- Global behaviour – in particular, issues of inequality in the distribution of wealth and poverty, responsibility of the developed countries for assistance to the less-developed ones.

Incentives for ethical behaviour may come from a variety of sources, and may have an impact at different levels: from individual incentives (the ethical and moral values of individuals) and occupational (professional) incentives, to incentives at the level of organization (these are practical measures stimulating and obliging employees to comply with applicable principles, regulations, laws, and ethical standards), to market and regulatory incentives (imposing sanctions and penalties on organizations and individuals who engage in unethical and unacceptable behaviour) [Razaee, 2007, p. 447].

It is crucial for the ethical attitude of organizations to create an adequate ethical climate, that is, stable, psychologically significant, shared perceptions employees hold concerning ethical procedures and policies existing in their company (based on observations rather than feelings or attitudes) [Wimbush and Shepard, 1994, pp. 637-647]. This ethical climate may be different in various organizations, depending on the particular interests of individual employees and teams, friendship between employees and their morality, social responsibility of the organization and its profitability and operational efficiency, as well as on principles, standard procedures, regulations and codes [Sims, 1992, pp. 505-513]. And it is exactly the strong ethical culture of a bank that can complement the formal instruments of corporate governance. It is stressed that this is all the more important in the cooperative sector, where market mechanisms (corporate governance) do not work and do not discipline organizations to behave appropriately [Diacon and Ennew, 1996, pp. 623-634].

Honesty in the world of business means not abusing trust and performing the duties which are assigned to participants of the financial market [Jackson, 1999, p. 13]. Still, the growing gap between financial institutions and their surrounding obscures the sense of responsibility of financial entities [Dembiński, 2004, p. 54].⁷

In the construction of ethical banking rules of key importance are [Dembiński, 2004, p. 58]:

⁷ The author points here to the paradox of misconceived responsibility: there is massive responsibility because of the assets involved and a diffused awareness of this responsibility due to the technological and institutional isolation of the financial institution.

- Personal ties between customers and operators;
- Charts and codes of ethics;
- Regulations for financial markets.

It seems, therefore, that the optimal solution would be to merge the corporate governance system with the ethical culture of institutions. Previously, ethics was rarely seen as the foundation of corporate governance [Sullivan, 2009, p. 3]. However, it may be argued that there is an interaction here which promotes building an appropriate framework for the operation of all entities. The adopted principles and codes of ethics support the organization's responsible attitude towards its stakeholders, which is the essence of corporate governance. At the same time, an effective system of corporate governance helps observe the code of ethics implemented by the institution.

A. Bhimani argues that codes of corporate governance promote certain ethical values and principles as well as some moral aspects of the proper conduct of individuals and organizations. These codes, taking into account the concepts of neoclassical economics, by definition introduce the dimension of moral values and ethical ideals in their economically rationalist argument [Bhimani, 2008, pp. 135-147].

Ethical choices within corporate governance are in particular related to how, to what extent, and in relation to whom the basic "virtues" of corporate governance (i.e., the principles concerning duties, responsibility, honesty and transparency) are adhered to. The moral choices (judgments) made in this area are determined by differences in the models of corporate governance. They concern the scope of stakeholders and their expectations to be complied with by the bank and the extent to which these expectations will be incorporated in the bundle of the bank's objectives. Moral judgments are also reflected in the criteria for assessing the success of the organization by attaching importance to the following issues: economic and operational efficiency, involvement of the stakeholders and creating a kind of "corporate citizenship", and, finally, reduction of the imbalance between different groups of stakeholders.⁸

Many argue that corporate codes of ethics can constitute an effective mechanism for governance by providing guidelines for economic attitudes. In particular, such codes are important when other instruments (market mechanisms, state intervention, and social and ethical climate) have not brought about socially optimal effects [Thomson, 2001]. Regulations are not always effective and not always help to enhance enterprise value. Thus, management ethics, ethical education, or social norms will often have better results than strict rules [He and Ho, 2011].

⁸ More in West [2009].

However, codes of ethics, despite being meant to control behaviour and attitudes, cannot be a substitute for morality, culture, and character [Razaee, 2007, p. 440].

It is worth noting that research carried out in mature economies has shown that organizations with good corporate governance achieve good results regardless of their regulatory environment [Bruno and Claessens, 2010]. It can therefore be concluded that of greatest importance are internal motivators of good corporate governance. But in a model based on self-regulation it is necessary to ensure internal and external supervision in order to enforce corporate governance requirements [Weismann, 2009].

An interesting example of promoting corporate honesty and social responsibility is the incorporation of this idea into the Dutch corporate governance code.⁹ It is worth noting that the core perspective of the code is “that a company is a long-term alliance between the various parties involved in the company.” Therefore, this model strongly emphasizes the perspective of stakeholders: the management and supervisory boards are responsible for taking into account the interests of different groups, and corporate social responsibility is seen as a component of the company’s primary strategy. It should be noted that in the original draft code the recommendations were even broader and suggested that institutional investors (including mutual funds) should increase their transparency regarding ESG issues (environmental, social and corporate governance). The final version of the Code contains a provision requiring the shareholders to act in accordance with the principles of “reasonableness and fairness.”

3. What kind of corporate governance rules should be adopted by banks?

It is essential for the construction of a new financial order to establish a regulatory strategy enhancing the stability of the operations of banks. This requires identifying critical areas of inefficiency in the existing regulations. The four most significant problems include [Acharya and Richardson, 2009, p. 25]:

- Banks are encouraged to undertake excessive risk;
- Regulatory safeguards are poorly designed and inadequately valued, resulting in the problem of institutions too big to fail;
- Growing opacity and the resulting counterparty credit risk externalities
- Existing regulations focus on the risks of individual institutions rather than on systemic risk.

⁹ More in Lambooy [2010].

These observations give rise to some overarching principles which should guide the regulations currently being developed [Acharya and Richardson, 2009, p. 30]:

- Strengthening internal management and internal audit within institutions and adjusting remuneration policy so as to reduce excessive risk-taking and diminish the level of financial leverage;
- Fair valuation of government guarantees and their exclusion in certain cases;
- Increasing transparency in order to reduce counterparty credit risk externalities;
- Implementing prudential regulations for large, complex financial institutions, based on their contribution to the risk of the financial system.

The fact that the financial sector is better developed and more stable [Barth et al., 2004] in countries whose governments support the private sector's ability to monitor banks is the starting point for the regulatory and supervisory authorities to determine the strategy for improvement of governance in banks. Thus, the stability of banks is founded not only on support for regulations and institutional supervision, but also for private monitoring (market discipline). Moreover, in order to improve corporate governance in banks, it is necessary to introduce strong and clear incentives for owners, creditors and supervisors so that they would properly carry out their tasks of monitoring and disciplining banks if the banks should take excessive risk [Capiro and Levine, 2002, p. 42].

The risk of over-regulation of the financial sector should be emphasized here. Although at the moment there is a consensus on the need to strengthen legal norms in order to prevent another significant increase in risk, it is also argued that it would be dangerous to create too many regulations or badly designed ones. Such regulations would lead to reduced efficiency and effectiveness of the financial system. And if the new regulations constrain innovation, which would otherwise benefit companies and individual customers, they could have adverse consequences for future economic growth [Mishkin, 2010].

Drafting new regulations for the functioning of the banking sector is nowadays an extremely difficult task – in the face of pressure to tighten regulation, increase supervision or even take “retaliatory” measures against banks, it is difficult to find a happy medium between dangerous under-regulation and dangerous over-regulation. As pointed out by the European Banking Federation, “policy-makers will need to strike a delicate balance between their instinctive reaction in times of stress to regulate and control on the one hand; and on the other, the need to preserve the financial sector's ability to serve the economy and society” [EBF, 2010, p. 2].

The EBF has developed principles that should guide the changes that are being currently introduced and are addressed both to regulators and supervisors, as well as the banking sector. These rules cover nine areas [EBF, 2010, p. 2]:

- Banking in an open market economy – Reforms should respect the values of openness, the freedom of capital movement, the freedom of establishment and a level playing field among financial institutions.
- Properly supervised banking – The model of banking supervision must ensure stability and functionality of the markets, as well as being in step with modern banking.
- Truly commercial banking – Banks must remain commercial in nature; therefore, the crisis-induced public intervention needs to be withdrawn as quickly as possible, in a coordinated and market-sensitive way. Enduring government intervention in the financial system harbours the danger of deactivating market mechanisms and distorting competition.
- Banking without size prescription – To make banking safer, policy-makers should focus on the systemic aspects of financial institutions rather than on their size. (This relates to an institution’s activities, the legal underpinning of its component units, its business model and the scale and nature of interconnectedness with others).
- Diverse banking models – The prescription of a specific banking model would limit innovative and successful business. Stable relations are important for banks – and a variety of banking profiles can offer this. Structural principles (legal form, regional principle, mandatory group membership) should not be prescribed.
- Customer-oriented banking – European regulators should continue to focus on banking customers, and in this regard there is a need to increase transparency and build confidence, notably in the field of credit intermediaries and information to consumers. The crisis has highlighted the importance of financial education.
- Robust banking – The banking business is highly sensitive to changes in capital requirements. Over-zealous tightening of the capital regime could have a dramatic impact on banking as well as on the economy (particularly if attention is not paid to the cumulative effect of the changes). Capital requirements must be appropriately calibrated to ensure stability and avoid a reduction in the availability of credit and other financial resources to the wider economy.
- Sustainable banking – Banks and other financial institutions must continue to re-examine the role they play in financing the growth of the real economy and enhancing financial stability. The banking business is crucially dependent

on public trust. Both the public good and the capacity of providers to fulfil their mandates in a competitive, efficient and cost-effective way, can be impaired by deficiencies in professional integrity, transparency and accountability. Banks must further improve risk management, align remuneration and compensation schemes with long-term value creation and gear incentive structures more strongly to customers' wishes and their long-term corporate interest.

- Adaptable banking – Banks must develop robust strategies to be able to adapt to continuously evolving market conditions and changes in the demand for banking services. Adaptability and creativity in such financial areas as change of funding sources, collateral shortages, improved securitization activity, as well as in harnessing technology, will help banks to better assist society in facing its own challenges.

In fact, the principles promoted by the EBF relate to the development of a banking system based on a regulation–self-regulation continuum. As the former head of the Financial Services Authority (FSA), H. Davies, rightly observed, no system of corporate governance will work efficiently without the involvement of shareholders. Regulators cannot be a substitute for interested and responsible owners, but they can to some extent support and complement them [Davies, 2003].

On the other hand, a set of voluntarily accepted recommendations and best practices cannot be an alternative to reliable oversight – both components complement each other and must co-exist together in order to create a stable, strong and dynamic global financial system [Ackermann, 2008]. The same regulations may in fact produce different effects, depending on the existing corporate governance structures in banks [Laeven and Levine, 2009]. In addition, one should bear in mind that incentives for the development of good corporate governance can be distorted in the face of financial threats and crises. Thus, it is all the more important to support regulatory governance with institutional structures of greater independence and transparency, i.e., to ensure best governance practices in supervisory institutions themselves [Das and Quintyn, 2002].

Therefore, one should seek an optimal balance between the regulation of the financial sector and the promotion of self-regulation. Neither regulations alone or corporate governance mechanisms alone can guarantee success. The best results can be achieved by supervisory regulations supporting strong corporate governance based on ethical foundations.

Conclusion

The global financial crisis has demonstrated the need for new paradigms, especially those pertaining to “a balance between economic freedom and discipline, competition and cooperation, self-regulation and intervention, centralization and decentralization, private and public ownership, self-financing and public financing, current and future consumption” [Frąckowiak, 2011, p. 81]. Indeed, it is necessary to redefine the role and organization of the state, society and the economy, and determine points of equilibrium anew.

There is no doubt that ethics and a sense of responsibility supported by a stronger regulatory system and improved supervisory institutions (and macro-prudential supervision) should be the core elements of an improved, stable and responsible financial system [European Commission, 2010d]. Legal standards should only serve as a support for grass-roots initiatives. It is unrealistic to expect that the monitoring and supervision of complex financial markets and institutions may be based solely on regulations, but this does not mean that the state may abandon these processes. An effective regulatory regime must be based on the desire of banks (and other institutions) to maintain high management standards and values as part of their corporate culture [Tomasic, 2011, p. 52].

Corporate governance, especially in the banking sector, should ensure that organizations are concerned with the good of all their stakeholders. However, honesty, transparency and responsibility must be mutual in nature [Marcinkowska, 2010].

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