

BANKS: REGULATION AND CORPORATE GOVERNANCE FRAMEWORK

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Abstract

The banking sector industry is somewhat unique because it is simultaneously consolidating and diversifying. Banks' major role in stabilising the financial systems of countries and in spurring their economic growth explains the particularities of their own corporate governance. The specificity of banks, the volatility of financial markets, increased competition and diversification expose banks to risks and challenges. The banking industry is heavily regulated and supervised in every country around the globe. This, in turn, establishes a particular corporate governance system. The paper lays out the specific attributes of banks that influence their regulatory and supervisory environment, which, in turn, creates a unique corporate governance framework for the banking industry. The paper emphasises the benefits and limits of regulations and supervision on banks' corporate governance and focuses its empirical results on the European Union countries.

Keywords: Banking, Supervision, Corporate Governance, Market discipline, Basel framework

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Introduction. Importance of banks and their governance

Significant attention has been given to the role of banks in the corporate governance of other firms. Banks have a major role in the functioning of firms, contributing to the formation, increase, monitoring and allocation of their capital and stimulating productivity growth. As a result, they have a major role in the governance of other firms. These responsibilities increase the importance and complexity of banks' own governance.

The importance of banks for countries' finances and for spurring economic growth explains the particularities of their own corporate governance. The topic of banks' corporate governance has been approached to a lesser extent and most authors agree that extended research in the area is necessary.

The specificity of banks, the volatility of financial markets, increased competition and diversification expose banks to risks and challenges. The increasing market orientation of banks has led to changes in approach to regulation and supervision. Visentini (1997) states that the observed forms of corporate governance of banks emerge in the course of their operations as entities having to respect the private interest of owners, on the one hand, and the public interest in the overall stability of the system, on the other hand.

The banking industry is heavily regulated and supervised in every country around the globe. This, in turn, establishes a particular corporate governance

system for banks, which is different from the traditional corporate governance of non-bank firms.

Will these circumstances develop to the point where corporate governance codes are modified in order to make provisions for the banking industry? Banks could also become more proactive in complying with corporate governance best principles, which could support the overall system of compliance.

The paper presents the main specific attributes of banks that influence their regulatory and supervisory environment in the sector, which, in turn, creates a unique corporate governance framework for the banking industry. We consider the following characteristics that are specific to banks: capital structure, equity ownership, transparency and disclosure, the stakeholder groups, competition and takeovers. The banking regulatory environment is emphasized by two areas: regulatory restrictions and Central Bank supervision in the banking industry. The conclusive part debates the benefits and limits of regulations and supervision on banks' corporate governance with the emphasis on market discipline as part of the Basel II Framework. The paper focuses its empirical results from studies on European Union countries.

I. Specific attributes of banks

I.1. Capital structure

An aspect that distinguishes banks from other firms is their capital structure, which is unique in two ways

(Macey and O'Hara, 2003). Firstly, banks have little equity relative to other firms and receive 90% of their funding typically from debt. Bond holders and depositors provide the rest. Second, banks hold illiquid assets that often take the form of loans without maturity. Banks have liabilities in the form of deposits that they issue to creditors or depositors, thus creating liquidity for the economy.

A mismatch between deposits and liabilities may cause a collective-action problem among depositors. This can cause the failure of a bank, with externalities effects. Consequently, the liquidity function may create problems in the governance of banks. High loan growth raises bank capital requirements, as regulators consider most loans to be risky assets. One regulatory measure against such risks is the deposit insurance, which is considered successful in achieving what had been a major objective of banking reform for at least a century, namely the prevention of banking panics²⁴.

Banks react to these risks through different mechanisms. Different size banks pursue different strategies. Small- to medium- size banks continue to concentrate on loans but seek to strengthen customer relationships by offering personal service. Large banks respond through securitisation, a process of converting assets into marketable securities. These strategies reflect banks' governance control.

1.2. Equity ownership

As with all publicly-owned firms, the diffuse and concentrated ownership of banks are aspects that influence their governance mechanisms. Diffuse ownership can effectively exert corporate control directly through their voting rights and indirectly through electing the board of directors. Information asymmetries are an impediment for shareholders and debt holders to exert control over management. In the case of banks, due to their opaqueness, diffuse shareholders and diffuse debt holders find it difficult to exercise control. This situation is managed by more concentrated ownership and increased regulation.

Concentrated ownership enhances firms' control and monitoring of its activity through a better flow of information. Large shareholders and large debt holders are more effective in exercising their rights, thus having more control over management. This context should theoretically lead to better governance of firms. In practice, evidence shows that large shareholders may exploit their interest in the firm, thus undermining its governance.

Generally, banks have a concentrated equity ownership, which makes it more difficult for small equity holders to exert influence over the management of banks. Controlled ownership by large investors may also affect the interest of debt holders – either diffuse or concentrated – and on other stakeholders,

leading to a more complex corporate governance environment for banks.

A legal system that prevents large shareholders controlling a bank from taking advantage of the small and diffuse stakeholders has the potential to stimulate good corporate governance.

1.3. Transparency and disclosure

Transparency is one of the main principles of corporate governance. This principle is applied to a lesser extent in the banking sector. The opaqueness of banks is factored by their sensitive operational environment: loan operations to individuals, to large entities and to governments, capital funding of firms, banks' interaction with Central Banks and governments.

An explanation for the lesser transparency is that the risk of banks' failure is not as high as the risk of non-financial firms' failure. It is often argued that banks are "too large to fail", in reference to the major stakes that governments have in these entities. In addition to funding the economy, banks also perform in a political context, which enhances the gravity of a potential failure. As a result, entities such as states and prudential supervisory bodies dominate the banking sector in order to minimise the risk of failure.

Literature presents different points of view with regard to the transparency of banks. Levine (2004) examines the implications of opaqueness for the governance of banks by diffuse equity holders and diffuse debt holders. Opaqueness may help controlling holders to exploit their stake, to facilitate the manipulation of loan operations and compensation packages. This comes at the expense of the long-run health of the banks, their diffuse shareholders and their diffuse debt holders. The opaqueness of banks may weaken market competitive forces, affecting the efficiency of the securities market. All stakeholders are negatively affected, including diffuse shareholders, customers and governments. Morgan (2002) states that "banks appear to be among the more opaque industries, but not the most opaque one". Macey and O'Hara (2003), based on a statement by Furfine (2001), argue the notoriously opaqueness of banks' balance sheet and the effects of the technology on the difficulty of monitoring banks by traditional regulation and supervision. Flannery et al (2002) consider that special government supervision can enhance banks' transparency.

Governments impose strong regulations on the banking system, by restricting the concentration of bank ownership. This is to avoid the concentration of power and control of banks, thus enhancing disclosure.

Improving the flow of information through increased disclosure enhances market discipline. This is the rationale behind the third pillar of the Basel Capital Accord, which is later discussed in the paper.

²⁴ Macey and O'Hara (2003), based on Friedman and Schwartz (1963)

I.4. Corporate governance context for banks: Stakeholders

From a generic perspective, banks are viewed as any firm with a broad range of stakeholders. In the case of banks, the group of claimants includes shareholders, who contribute to the formation of capital, as well as other categories who have a direct interest, such as: creditors, employees, general public, governments and regulators.

Referring to corporate governance models and viewing a comparison between the Anglo-American and the Franco-German models, Macey and O'Hara (2003) note the strange fact that paradigms of corporate governance differ on the basis of national boundaries rather than on the basis of the indigenous characteristics of the firms being governed. The Anglo-American corporate governance approach focuses on the interests of maximizing shareholder value, while the Franco-German model considers the interests of all stakeholders.

In the case of banks, the two authors find a hybrid approach, in which most firms are governed according to the US model, while banks are governed according to the Franco-German paradigm. The governance of banks is targeted at the interest of its shareholders, employees, creditors, local communities, customers and regulators.

There is a significant public dimension to the banking firm. In the banking context, depositors' savings and government interests are at stake (Macey and O'Hara, 2003). When the social costs of an outcome exceed the private costs of an outcome, there is a negative externality effect. In this case the failure of a bank can influence the functioning of the entire banking system. The positive externality effect is also acknowledged: good individual performance improves the health of the banking system, which benefits all stakeholder groups.

In this context, the corporate governance model argues that shareholders are not the exclusive beneficiaries of fiduciary duties. Non-shareholder constituencies claim fiduciary duties from management, in certain circumstances requesting higher protection than the duty performed in relation to shareholders. The special nature of banking requires that management duties are more extensive than those of other directors. Managers function in the light of two distinct sets of interests: one is the private interest internal to the firm and the other is the public interest external to the firm. From the banks' governance perspective, the agent seeks that behaviour beneficial to the firm's interest does not compromise the public interest (Ciancanelli and Gonzales, 2000).

I.5. Mechanisms of corporate governance: product competition and takeovers

Shleifer and Vishny (1997) analysed solutions for solving the problems of banks' corporate governance.

One solution is competition, referring to product competition and takeovers. The two authors conclude that product competition, although being the most powerful force towards economic efficiency, can not solve the problem of corporate governance. Analysing the takeover element, the two authors consider it as a second corporate governance mechanism only in the US and the UK markets.

Levine (2004) analyses the effects of opaqueness on the competition in the banking sector. The opaqueness of banks can weaken competitive forces, affecting product competition and the takeover activity. The author observes that product market competition is less frequent in the banking sector due to the personal relationships that banks establish with their clients.

Regarding the takeover activity in the banking sector, empirical research on cross-border mergers and acquisition of financial institutions shows that, between 1996 and 2000, the bulk of financial restructuring occurred on an in-sector and domestic basis. For Europe, cross-border intra-European mergers and acquisitions amounted to 29% of the European total. These figures differ considerably across sectors. The banking sector amounted to 17% of the total figure. According to Walter (2003), these figures possibly suggest somewhat different economic pressures at work. Authors debate whether the low percentage of cross-border activity in the banking sector reflects the abuse of national provisions, formally based on current legislative EU banking framework in a protectionist manner.

Among the 15 EU former member countries, the cross-border penetration in Luxembourg and Sweden is higher than the average. As at 2003, Luxembourg had a share of foreign banks in total assets of 94% and Sweden of 59%²⁵. The extent of cross-border penetration is greater in the newly acceded EU countries than in the 15 former EU countries. The new EU member states have a share of foreign banks in total assets between 60-100%. They also have a higher degree of concentration than in the euro zone (Lannoo, 2005).

Hostile takeovers are rare in the banking sector, due to stricter regulatory requirements.

The decrease in product competition and the tension present in the cross-border takeover activity may stimulate competition for good governance of banks. Supervisory practices could be further developed via benchmarking based on best practices.

II. Regulation and supervision in the banking industry

II.1. Overview

The need to streamline the structure of the financial regulation and supervision and the requirements to adapt this structure to market developments led to

²⁵ Source: ECB (2003)

reforms in the financial sector and, particularly, in banking. The increase in regulations in the banking sector took place during the second half of last decade.

Banking crises, rapid technological change and the continuing globalization of banking, the overall importance of banks for the economic development and their political context have led national and multilateral policy makers to focus greater attention on the important role of bank regulation and supervision in recent years. This focus is reinforced by the fact that “one of the important trends has been, and continues to be, a move away from regulation and towards supervision”. (Crockett, 2001).

The paper analyses the following aspects that have a key impact on the corporate governance of banks:

- Banking supervision in EU: the role of Central Banks
- Regulatory restrictions in the banking industry
- Regulation and supervision: impact on banks' corporate governance

II.2. Banking supervision in Europe: the role of Central Banks

Overview on banking supervision

Banking supervision, based on ongoing analytical review of banks, represents one of the key factors in maintaining stability and confidence in the financial system. In addition to effective supervision, other factors necessary for the stability of banking and financial systems and markets include sound and sustainable macroeconomic policies of banking and financial systems and markets, a well-developed financial sector infrastructure, effective market discipline and an adequate banking sector safety net.

The banking supervisory process includes the establishment of a legal framework for the banking sector, the designation of regulatory and supervisory authorities and the enhancement of regulations that limit the level of risk that banks are allowed to take.

In order to be effective, the supervisory authority must have appropriate enforcement powers and an adequate degree of autonomy, in order to resist undue pressures from the government, banks and shareholders, depositors and creditors, borrowers and other entities that use financial services. Supervisory authorities should command the respect of the banks they oversee.

All banking systems have at least one regulatory and supervisory authority. However, the locus, structure and specific responsibilities of each authority are different as a consequence of the legal and economic environment of a particular country. Decisions on regulatory and supervisory authority for the national banking sector is assigned to the National Central Banks (NCBs), but the global current trend is for the consolidation of all financial supervision in a separate entity, outside the Central Bank, with the two

entities cooperating for sustaining an efficient supervisory environment.

NCBs role in banking supervision

NCBs have a significant role in regulating the banking system. According to Healey (2001), the involvement of Central Banks in their lender of last resort role and monetary policy objectives has led them to be intrinsically interested in the stability and general health of the financial system. Concerns over the moral hazard that might result from the emergency assistance and the potential cost of financial instability in turn led NCBs to take a closer interest in the behaviour of individual banks. Often, but not always, this resulted in the NCBs supervising and, if necessary, regulating the banking system.

After Basel II was issued, a question was posed by many countries and policy makers with respect to the structure of banking supervision: whether there should be a single bank supervisory authority, or multiple bank supervisors, or whether a Central Bank should play a role in banking supervision.

Countries decide on the contentious issue or whether to assign responsibility for banking supervision to the Central Bank in addition to its responsibility for monetary policy. The trend in Europe is to assign the task of supervision to an authority different and independent from the Central Bank. Since the launch of the euro in 1999, the European Central Bank (ECB) is in charge of monetary policy of countries participating in the eurozone, but not bank regulation and supervision, which still resides in the individual countries. In all cases, however, the Central Bank and the supervisory authority are expected to share information and to cooperate. This expectation is sometimes formalized by a memorandum of Understanding (MoU).

We find differences between the EU member countries regarding the role of NCBs in banking supervision. The most significant difference is between the UK and the euro area countries and is principally caused by the following aspects:

- the monetary policy conducted by the Bank of England in the UK and the ECB in the euro area (NCB's having had lost this role);
- the difference between the UK and the Continental European corporate governance systems.

ECB supports the preservation of a fundamental role for NCBs in prudential supervision in the euro area countries. In most EU countries NCBs are either directly responsible for prudential supervision or strongly involved in this activity. In some countries adjustments in the institutional structure have recently been made. In other countries the debate and further adjustment is ongoing.

Banking supervision entails an array of tasks that can improve the governance of banks, hence the importance of involving the NCBs in this area.

According to the ECB, supervisory functions can be grouped into three classes:

- *Investor protection activities*, which are focused mainly on the issuance and enforcement of rules on the conduct of business and the disclosure of information;
- *Micro-prudential supervision*, which aims at the protection of depositors and other retail creditors;
- *Macro-prudential analysis*, which encompasses all activities aimed at monitoring the exposure to systemic risk and at identifying potential threats to stability arising from macroeconomic and financial market developments.

While the third type of task is performed, in some way, by all NCBs, the activities relating to investor protection, especially in the securities markets, are very rarely included in their mandate. This enforces the view that cooperation with the supervisory authority that overlooks the entire financial sector is necessary for improving the corporate governance of the banking industry, but also the stock market operational framework.

Arguments regarding central banking supervisory role

The conceptual literature is split between the relative advantages and disadvantages of the Central Bank being a bank supervisor.

Arguments in favour of combining prudential supervision with Central Banking can be grouped into three basic categories: (1) information-related synergies between supervision and core central banking functions; (2) focus on systemic risk; and (3) independence and technical expertise.

Information synergies. Assigning supervisory functions to the Central Bank would facilitate direct access to pertinent information and readily available knowledge of the condition and performance of banks. Furthermore, should there be a crisis in financial markets, the NCB would be inevitably involved. NCB's supervisory input is crucial for assessing whether an illiquid bank asking for emergency liquidity assistance is solvent, for instance, in order to limit the scope for moral hazard.

Focus on systemic risk. The accessibility to information, in turn, can help it identify and respond to the emergence of a potential systemic problem in a timely manner. This could assist monetary policy to the extent that it plays out through the credit channel and would thus monitor credit risks. Supervisory responsibility also may help NCBs implement their lender-of-last resort functions better, distinguishing solvent but illiquid banks from simply insolvent banks. The systemic risk argument relies on the close relationship between prudential controls of individual intermediaries and the assessment of risks for the financial system as a whole.

Independence and expertise. Independence of supervisory authority from political interference is

important for effective supervision, particularly in countries where governments have more control over banks. NCBs independence protects the banking system from external interference, although it does not exclude the role of governments in certain cases of crisis (e.g. tax concerns). In addition, NCBs are generally recognised as sources of excellent research and analysis on the banking and financial system.

There are also *arguments presented against attributing supervisory powers to the NCBs*, and, instead, giving fully this role to a single agency outside the NCB. According to the research done by the ECB, there are three such main arguments: (1) the conflict of interest between supervision and monetary policy and moral hazard; (2) the tendency towards conglomeration and the blurring of the distinctions between financial products and intermediaries; and (3) the need to avoid an excessive concentration of power in the NCB. These arguments do not have strong empirical evidence or sufficient ground.

The *conflict of interest* argument is related to the moral hazard, which is linked to the role of NCBs in crisis management, stemming from their supervisory responsibilities, by excessive risk-taking. The NCB would come to the rescue of the banks via emergency liquidity assistance (or by manipulating interest rates), possibly also seeking to cover up a failure in the supervisory function. Nevertheless, the importance of moral hazard may sometimes be overstated in general, since managers and shareholders of defaulting institutions, for instance, can be appropriately penalised. The NCB would not jeopardize its credibility as a monetary authority in the circumstances of such crisis.

The *conglomeration argument* has been widely used in recent debates. This argument relates to the creation of the universal bank and the links between banks, securities companies, asset managers and insurance companies, hence different types of intermediaries would compete in the same market. Central Banks traditionally play a role in banking supervision, i.e. in the monitoring of counterparties, who are an essential component in the transmission of monetary policy.

The *concentration of power* argument is strictly linked to the previous ones. Attributing regulatory and supervisory tasks to an independent NCB, especially if extended to the whole financial sector, might lead to potential abuse in the performance of public functions.

Banking supervision in the EU countries

The euro area, the UK and the US are three zones with different financial operational experiences, thus having different financial supervisory models. ECB's position is that NCBs operating in the euro area and the US are carrying out supervisory tasks in an effective way. UK's model based on a single financial authority (FSA) has shown little experience regarding its performance thus far.

Following the introduction of the euro, arguments in favour of a separation of prudential supervision and central banking have lost most of their force, while those in favour of combining them have become even more prominent. In particular, an institutional framework in which the ECB's responsibilities for monetary policy in the euro area are coupled with extensive supervisory responsibilities of NCBs in domestic markets and with reinforced co-operation at an area-wide level, would seem appropriate to tackle the changes triggered by the introduction of the euro.

The study by Barth and all (2006) that compares the supervisory role of the Central Bank in 153 countries from all continents shows that approximately 60% of the countries assign the Central Bank some responsibility in banking supervision. This includes 69 countries in which the Central Bank is the single bank supervisory authority. Only two countries of the thirteen countries represented in the Basel Committee (Italy and the Netherlands) have the Central Bank as the only authority responsible for banking supervision. In 26 countries that have a multiple-bank-supervisors system, 21 of them assign some bank supervisory responsibility to the Central Bank, including the United States.

At the *European Union* level, there is trend towards converging the supervisory practices across countries. This process is under current review and implementation by the Committee of European Banking Supervisors (CEBS) which overlooks the Supervisory practices across the EU, by providing advice to the European Commission on banking policy issues and promoting cooperation and convergence of supervisory practice across the EU. This Committee fosters corporate governance principles in the EU banking sector.

CEBS published a report in June 2006 on the progress on supervisory convergence in banking. The process is focused on three main areas:

- Fostering supervisory convergence, which has as main priority the implementation of the Capital Requirements Directive, with guidelines on transparency and disclosure of supervisory rules and guidance (supervisory disclosure), the advanced approached for credit and operational risk and cooperation between home and host supervisors (supervisory review process).
- Enhancing cost-efficiency of the EU system, contributing to the finalisation of common frameworks for reporting that allows banking institutions to use a common set of templates and data formats when transmitting financial and prudential data to supervisors.
- Improving cross-border supervision, by providing guidelines on cooperation between consolidating and host supervisors

and on fostering a common European supervisory culture.

The actual impact of CEBS efforts will be visible only when CEBS guidelines will be operationally put into practice.

United Kingdom (UK) has a different system of financial and banking supervision that is different from other European systems, due in part to the fact that the country is not part of the euro zone.

The City of London has a history of encouraging good corporate governance based on application of simple principles to the individual and distinct circumstances of each entity. The UK system of business regulation is principles rather than rules based, thus reducing the cost to global businesses of introducing procedures to comply with detailed regulations, many of which constrain the adoption of market discipline and innovation in all sectors. The responsibility for the corporate governance system in the UK belongs to the Financial Reporting Council.

The responsibility for full financial supervision is assigned to a separate authority: the Financial Services Authority (FSA). The MoU regarding banking supervision establishes a framework for sharing information and for cooperation among the Treasury, the Bank of England and the Financial Supervisory Authority.

II.2 Regulatory restrictions in the banking industry

As banks became more important for the overall success of the economy, in addition to using banks to finance expenditures directly, governments find it important to control them through regulation, imposing several restrictions to their activity.

The paper considers the following regulatory restrictions to the banking activity:

- Entry of new domestic and foreign banks;
- Restriction on bank activities;
- Safety net support;
- Disclosure of accurate comparable information;
- Government ownership.

Market monitoring could also be considered as a component of banking regulatory environment. This paper approaches market monitoring as an aspect that sustains the importance of banking regulation for the corporate governance of banks.

Entry restrictions

Governments typically influence banking by regulating the entry of new banks. Banks' entry could destabilise economies under certain circumstances. Restrictions on bank entry might be caused by the natural monopoly and information asymmetries possessed by individual banks. The entry of new banks exposes consumers to the risk of fraud that could influence other banks by releasing misleading

information to customers, to the extent that depositors realise that they do not have appropriate information about the risks taken by banks. In a country banks may demand barriers to entry in order to limit competition and some regulators respond to the demands, to help them maintain political control. Nonetheless, restricting competition in banking can have negative effects on their operational environment.

There are positive effects of banks entry. Foreign banks can provide host country supervisors with additional challenges in terms of developing a comprehensive understanding of foreign banks' operations. In certain circumstances, foreign banks may also adopt home country effective supervision, in which case these are considered better practice. The potential for foreign banks to enter a country may spur domestic banks to operate more efficiently. These cases can lead to competition for best supervisory practices between countries and banks operating in different jurisdictions, which can be a positive influence on the corporate governance of banks.

Restrictions on bank activities

The definition of the "bank" itself requires activity restrictions. Banks must be licensed and are subjected to regulations specifying the activities in which they are permitted to engage. Countries may restrict banks to a narrow range of activities, or allow them to engage in a broad array. A bank may not perform the same activities around the world. Regulatory authorities determine the extent to which activities of banks differ across countries, the extent to which they differ from non-bank firms and the extent to which banks and non-bank firms may combine to form financial (i.e. bank and non-bank financial) or mixed conglomerates.

Such activities refer to the following:

- Securities: the ability of banks to engage in the business of securities underwriting, brokering, dealing and all aspects of the mutual fund industry;
- Insurance: the ability of banks to engage in insurance underwriting and selling;
- Real Estate: the ability of banks to engage in real estate investment, development and management.

Safety net support

A critical part of the regulatory framework is safety net available to banks, because it affects stakeholders' incentives to monitor banks. The safety net has two components:

- The lender of last resort
- The deposit insurance system

The lender of last resort component promotes market discipline to the extent that NCBs provide

unsubsidised support to illiquid but solvent banks and allows uninsured creditors to suffer losses. This role, which is mostly performed by NCBs, raises moral hazard issues and could lead to banking crisis if abused.

The effects of regulation of the banking system on various economies may depend on whether or not a country has an explicit deposit insurance scheme and the characteristics of this mechanism. Theory provides conflicting predictions about the impact of deposit insurance on bank stability. The core arguments in favour of deposit insurance derive from the view that depositors have a difficult time assessing the quality of bank assets that creates a contagion effect, determined by depositors. By contrast, many models emphasize that deposit insurance intensifies the moral hazard problem in banking, encouraging excessive risk-taking behaviours that overwhelm any stabilisation benefits.

Disclosure

Information gaps exist at the level where regulators and supervisors with imperfect information about banks seek to design rules and procedures that induce banks to behave in desirable ways. Information asymmetries make it difficult for the market participants (depositors, equity holders, other creditors and rating agencies) to monitor and control bank managers.

One mechanism for fostering market monitoring of banks is by requiring the disclosure of reliable, comprehensive and timely information, which is endorsed by Basel's II pillar on market discipline. His regulatory framework stresses the effective use of information disclosure to strengthen market discipline of banks.

Participating banks are expected to disclose:

- Risk exposure;
- Capital adequacy;
- Methods for computing capital requirements;
- All material information, which, if omitted or miss-stated, could affect the decision-making of the agent using the information;
- Disclosure should take place on a semi-annual basis; or quarterly in the case of risk exposure, especially if the bank engages in global activities.

Government ownership

Banks may be government-owned, foreign-owned or domestically (private) owned. The public interest view sees government ownership of banks facilitating the mobilisation of savings and the allocation of resources towards strategic projects with long-term benefits for the economy and overcoming market failures. The private interest view argues that

governments tend to politicise strategic decisions and hinder economic efficiency.

General assessment

Because banks affect economic prosperity, research (Barth and all, 2006) examines which regulatory practices improve the functioning of banks. They find major cross-country diversity in banking regulatory practices.

The minimum required capital ratios, varies from 4% to 20% around the world. Actual capital ratios vary from almost 0 to almost 80%. The study shows that securities activities are the least restricted in countries, while real estate activities are the most restricted. Approximately 50% of all countries offer explicit deposit insurance, a more than threefold increase in the last twenty years. Government ownership of banks varies from 0 to 98% of total banking system assets. Nonetheless, the trends in banks' ownership according to recent research shows that in the majority of cases the government ownership percentage declined. In the case of foreign ownership of banks, research evidences a wide variation in this type of ownership that varies from 0 to 100% of a country's banking sector. In many cases, the foreign-ownership percentages are quite high as a result of privatisation and subsequent foreign purchase of previously government-owned banks since 1990. Consequently, the correlation between the government ownership and the foreign ownership is negative.

Most studies on banks indicate that countries that adopt regulations forcing the disclosure of accurate, comparable information about banks to the private sector tend to have better developed banks. Nevertheless, the results of the studies also reveal regional coordination and harmonisation of bank regulations.

III. Regulation and supervision: impact on banks' corporate governance

III.1. Basel Framework

Various studies find that empowering direct official supervision of banks and strengthening capital standards do not lead to improvements in banking performance and social welfare. In contrast, supervisory and regulatory policies that facilitate market monitoring of banks improve their operations.

The solidity of the system of corporate governance in a business community creates a framework with a lesser need for detailed regulation to ensure effective compliance with best practice standards (FRC, 2006). There is a difference between the UK and the Continental European systems of corporate governance that reflects on the banking system, its supervision and its governance. The system of corporate governance of a country can influence on reducing the pressure from the regulatory

environment by applying a market discipline that banks would have to follow.

We consider Basel Framework to be the bridge between the strong regulatory system for banks and their corporate governance system. Basel II Framework is the approach to regulation and supervision adopted by the Basel Committee on Banking Supervision²⁶. It is an array of regulations and principles with the objective to soften the banking regulatory environment, in order to allow banks to comply with regulations and best practice principles in a flexible, yet thorough manner, creating a protective environment for the financial system as a whole. Basel Framework embraces "best practice" in bank regulation.

III.2. Market monitoring and market discipline

In addition to regulation on capital requirements and asset allocations, there is a trend for encouraging private monitoring of banks. Supervisory authorities may require banks to obtain and publish certified audits or ratings from international rating firms. Over the years, many economists have advocated greater reliance on market monitoring. Basel I did not acknowledge this aspect. Basel II includes this aspect as one of its three pillars.

"Market discipline is forward-looking and inherently flexible and adaptive. One of the principal merits of market discipline is that bank directors and managers are faced with the burden of proving to the market that the bank is not taking excessive risks rather than subjecting officials to the burden of proving, in a review process, that the bank is taking excessive risks. This facilitates better corporate governance by making clear that the directors and managers of a bank are responsible for its risk exposure." (Herring, 2004)

"Society needs to be alert as to how a seemingly "best practice" regulatory framework can be gamed by the regulates. This evolutionary view is consistent with greater reliance on market discipline". (Barth and all, 2006)

"Supervisors should encourage and pursue market discipline by encouraging good corporate governance and enhancing market transparency and surveillance". (BIS, 2006)

²⁶ The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. Pillar 1 of the new Basel Capital Accord refers to the minimum capital requirement. Pillar 2 refers to the supervisory review process; it complements the minimum capital requirement of pillar 1 and looks at a bank's internal procedures to manage and control risk. Pillar 3 strengthens the role of market discipline. For the original Basel II document, see Bank of International Settlements (BIS) publications.

All governments assert that they are following Basel regulation, although research evidence that differences in implementation are significant. Research by Barth and all (2006) analyses the importance of Basel II for the performance of the banking system. The results regarding the third pillar – effective use of information disclosure to strengthen market discipline of banks – indicate that countries that adopt regulations forcing the disclosure of accurate, comparable information about banks to the private sector tend to have better developed banks, hence a credible banking sector. Furthermore, countries with proactive approach to private monitoring regulations enjoy lower bank interest rate margins and lower bank overhead costs, which suggests greater efficiency. Countries that facilitate private sector governance of banks through regulations requiring banks to disclose relevant information to the public tend to have a higher degree of credibility (integrity in lending). Regarding the impact of investor protection laws on the governance of banks, research finds that strengthening the legal rights of shareholders through accurate disclosure boost the market value of banks.

The above evidence enhances the importance of regulatory and supervisory policies that facilitate market discipline of banks.

III.3. Best practice principles in banking

In addition to the regulations provisioned by the Basel II Framework, the Basel Committee issued a document on corporate governance to help ensure the adoption and implementation of sound corporate governance practices by banking organisations²⁷. This is not intended to establish a new regulatory framework, but rather to assist banking organisations in enhancing their corporate governance frameworks.

²⁷ There are 8 principles viewed as important elements of an effective corporate governance process:

(1) Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank; (2) The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization; (3) The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization; (4) The board should ensure that there is appropriate oversight by senior management consistent with board policy; (5) The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors and internal control functions; (6) The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment; (7) The bank should be governed in a transparent manner; (8) The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures that impede transparency.

The principles set forth by the Basel Committee are applicable whether or not a country chooses to adopt the Basel II Framework. The principles recognise the importance of sound corporate governance practices and the responsibility of the board of directors and senior management to manage the risk profile of the banking institution.

Corporate governance influences the banking activity conducted by the board and management by affecting:

- the setting of corporate objectives;
- bank's business on a day-to-day basis;
- the accountability to their shareholders and other recognised stakeholders;
- the compliance with applicable laws and regulations;
- the protection of the interests of depositors.

Conclusive remarks

Good corporate governance requires effective legal, regulatory and institutional foundations that can affect market integrity and overall economic performance, even though such factors are often outside the scope of banking supervision. Nevertheless, banks' supervisory authorities have the moral obligation to comply with these principles, in order to maintain credibility and a competitive position within the banking sector.

Authors advise that care is required in using the phrase "strengthening official regulation and supervision" where banks are concerned, suggesting that the message should imply that this means adopting policies that facilitate private monitoring of banks, which enhances their efficiency and good governance.

Since the banking sector has the strongest regulatory environment among all sectors, the current trend will change the industry's corporate governance, by determining banks' boards to follow certain best practice principles rather than comply with enforced regulation by states. Nonetheless, current financial market crisis might determine supervisory bodies to adjust corporate governance best principles, which would actually *empower* banks to comply with these principles.

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