CORPORATE GOVERNANCE IN BANKS: PROBLEMS AND REMEDIES*

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Abstract: Weak and ineffective corporate governance mechanisms in banks are pointed out as the main factors contributing to the recent financial crisis. Deep changes in this area are necessary to reinforce the financial sector stability. The paper presents key aspects requiring reforms: the role, constitution and accountability of board, risk management, management remuneration, transparency. New regulations and guidance are presented, creating the foundations for a new order of the financial market. The paper also points out the banks' stakeholders' accountability.

Keywords: banks, corporate governance, financial sector regulations and reform, risk management, board of directors accountability, directors remuneration, banks' transparency.

JEL Classification: G34, G21, G28, G00.

Introduction

Each turmoil (and especially a crisis) in the financial markets brings a wave of re-adjustments and re-regulations. After analysis of the causes of the problems the regulators seek to establish new laws, which in their opinion will fix the system and make the supervision of the market and its participants more effective in order to avoid a repetition of such difficulties.

The subprime financial crisis evidenced many problems specifically connected with regulations and attitudes of many actors (in particular the financial sector). The main guilt for the collapse of the financial markets was – not unduly – assigned to banks; the weakness and inadequacy of the mechanisms of corporate governance in these institutions was indicated.

This paper aims to present the specificity of the corporate governance of banks and indicate the main deficiencies in the bank governance system. The key goal of the paper is to describe key aspects requiring reforms: the role, constitution and accountability of board of directors, risk management function, management remuneration system, banks' transparency; and to present new regulations of the financial market.

The main research methods used in the paper are the review and critical analysis of literature and study of the regulations; based on that, a method of logical deduction is applied; the

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* The project was funded by the National Science Centre (Narodowe Centrum Nauki).

analysis of numerical data presented (based on case studies retrieved from literature and financial analysis of banks' aggregate data) allow for an illustration of the issues discussed.

The specificity of the corporate governance of banks

A bank's failure to follow good practices in corporate governance and the lack of effective governance are among the most important internal factors which may endanger the solvency of a bank.[1]

Corporate governance in banks differs from the standard (typical for other companies), which is due to several issues[2]:

- banks are subject to special regulations and supervision by state agencies (monitoring activities of the bank are therefore mirrored); supervision of banks is also exercised by the purchasers of securities issued by banks and depositors ("market discipline", "private monitoring");
- the bankruptcy of a bank raises social costs, which does not happen in the case of other kinds of entities' collapse; this affects the behavior of other banks and regulators;
- regulations and measures of safety net substantially change the behavior of owners, managers and customers of the banks; rules can be counterproductive, leading to undesirable behaviour management (take increased risk) which expose well-being of stakeholders of the bank (in particular the depositors and owners);
- between the bank and its clients there are fiduciary relationships raising additional relationships and agency costs;
- problem principal-agent is more complex in banks, among others due to the asymmetry of information not only between owners and managers, but also between owners, borrowers, depositors, managers and supervisors;
- the number of parties with a stake in an institution's activity complicates the governance of financial institutions.

To sum up, depositors, shareholders and regulators are concerned with the robustness of corporate governance mechanisms. The added regulatory dimension makes the analysis of corporate governance of opaque banking firms more complex than in non-financial firms (Wilson, Casu, Girardone, Molyneux, 2010).

In the case of banks therefore, corporate governance needs to be perceived as a need of such conduct of an institution, which would force the management to protect the best interests of all stakeholders and ensure responsible behaviour and attitudes (Tirole, 2001). Corporate fairness,

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1 The issue of bank bankruptcy is discussed in detail in: D.T. Llewellyn (2002), W.R. Miller (1996, January), Office of the Comptroller of the Currency (2001, January).
2 For further discussion read: D.T. Llewellyn (2002), M. Marcinkowska (2009) P. Cincanelli, J.A. Reyes-Gonzalez (2000, June), B.E. Gup (2007), R. Adams, H. Mehran (2003, April).

transparency and accountability are thus the main objectives of corporate governance, taking into account the corporate "democracy", which is the broad participation of stakeholders (R.E. Basinger et al., 2005)[3].

One must have in mind that there is no one model of corporate governance adaptable to all banks. Other goals, and therefore supervisory systems, will be in banks: private, cooperative and state; in the local and global banks; universal banks and investment (etc.); though priorities remain the same.

In the banking sector corporate governance is therefore a way of business and affairs of the bank by the management and the board, affecting how they (BCBS, 2006, February):

- define the objectives and goals;
- lead current bank activities;
- fulfill the obligation of accountability to shareholders and take into account the interests of stakeholders;
- apply the requirement to operate safely and to ensure a good financial situation and compliance with applicable regulations;
- protect the interests of depositors (and other clients and creditors).

Shortcomings in the governance of large financial groups have indicated that these may trigger (indirectly) systemic risks. Regulators and financial supervisors take action to ensure an individual bank's stability; in the case of systemically important banks this would result in the pursuit of overall financial stability. The main issues of corporate governance matters with specific systemic impact are: the "gatekeepers" (esp. auditors and credit rating agencies), corporate values and codes of conduct of banks, risk management and internal governance of banks managerial incentives to act in an appropriate manner, accounting (and valuation) rules (E. Wymeersch, 2008, October).

Moreover, there is some scepticism about the effectiveness of the 'comply or explain' approach to corporate governance (FRC, 2011 December). Analysis of the statements on the application of corporate governance indicates that a vast majority of companies did not present an explanation of the reasons to withdraw from the application of certain rules or the clarification is made with low quality information. This confirms the need for support mechanisms employed by the regulator and the requirement that companies monitor statements made by the regulator and take an appropriate response to the lack of or insufficient explanation (D. Seidl, P. Sanderson, J. Roberts, 2012).

As pointed out by the European Commission, the "comply or explain" approach would work much more effectively if specific monitoring bodies (such as regulatory bodies for securities,

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3 The rights of stakeholders and active collaboration with them are also emphasized in the principles of OECD - OECD (2004) Principles of Corporate Governance. It is even emphasized that balancing the interests of all stakeholders positively affects the stability of banks, eliminating (or reducing) potential conflicts - K. Zalega (2003, July).

stock exchanges or other bodies) were entitled to check whether the available information (in particular the explanation) has an appropriate informative value and is appropriately broad. It is emphasized, however, that these institutions should not interfere with the content of the information disclosed or evaluate the solutions adopted by the company – it should still be a task left to the market (EC 2011, April 5).

Key areas of failure of corporate governance in banks

The confidence of the public (in a bank and the entire banking system) is necessary for a proper functioning of the financial system and economy. Effective corporate governance practices are fundamental to gain and maintain this confidence (BCBS 2006, February). As the recent Edelman "trust barometer" study shows, banks and financial services are the two least trusted industry sectors (for the second year in a row)[4].

Trust is a basic prerequisite for a proper functioning of banks, therefore it is necessary to carry out fundamental reforms that will bring inner harmony and allow the recovery of the public trust. Therefore, an in-depth analysis of the recent crisis causes should be done. Particularly considering that the rules of proper conduct of banking business exist and are being implemented, but it is mainly the deficiencies in corporate governance which are to blame for the recent financial crisis[5]. This raises the question: Were the rules inadequate or poorly implemented?

Analyses of the causes of the crisis lead to indicate several issues requiring a re-structuring and strengthening of standards; these issues concern (Kirkpatrick, 2009, September, A. Turner, 2009, March, D.Walker, 2009, November 26):

- the role, tasks and responsibilities of the board, as well as its size, organization and composition (members) and the functioning of this body and the assessment of its work;
- control of bank risk exposure;
- evaluation of executives and its incentive pay;
- transparency of the bank supervisory board that allows for the assessment of its activities (both by institutional and private monitoring);
- ownership structure of banks and the role of institutional investors.

In order to avoid a similar financial crisis in the future, regulators of financial markets are planning to establish standards for sealing the system in these areas.

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4 Authors comment that the financial meltdown throughout the Euro Zone has had a particularly negative impact on trust and the persisting negative economic climate is going to make the recovery of trust in that region even more difficult in 2012. Edelman (2012, January 19)

5 It should be however stressed that an analysis performed by Adams (for the period 1996–2007) showed that the governance of financial firms is, on average, not obviously worse than in non-financial firms. See: R. Adams (2009, April).

The board of directors

The board of directors is the first level of supervision over the activities of the bank and its management. The board is ultimately responsible for the activities and results of the bank, for the maintenance of stability and financial soundness. The powers and rules of the board are specified in the law and the statute of a bank. The mode of operation should be specified in the rules of procedure of the board.

The core competences of the board forming the foundations of the bank activities include: approving and overseeing the strategic objectives of the bank and its corporate values, overseeing the work of the management board and the determination of the scope of the obligations and liability of the management members, the establishment of guidelines for the acceptable level of risk, overseeing the introduction of the management system (consisting at least of the system of risk management and internal control system), and assessment of the adequacy and effectiveness of the system.

If these tasks are to be performed, certain conditions concerning the organization of the council and its members must be duly met. In this first issue the question of the creation and functioning of the committees of the board should be taken into account in particular.

The Polish good practice (Dobre praktyki…, 2011) recommends that the Supervisory Board has at least the Audit Committee (it should include at least one member of the independent). Large European banks typically create committees: audit, remuneration, nomination, risk; in rare cases also: strategy, social responsibility, credit, mediation, quality, technology, etc. (Nestor Advisors 2008). In the case of banks it is currently postulated that they should form the risk committees, since it is mainly insufficient supervision of this area which is the most visible imperfection preventing bank governance.

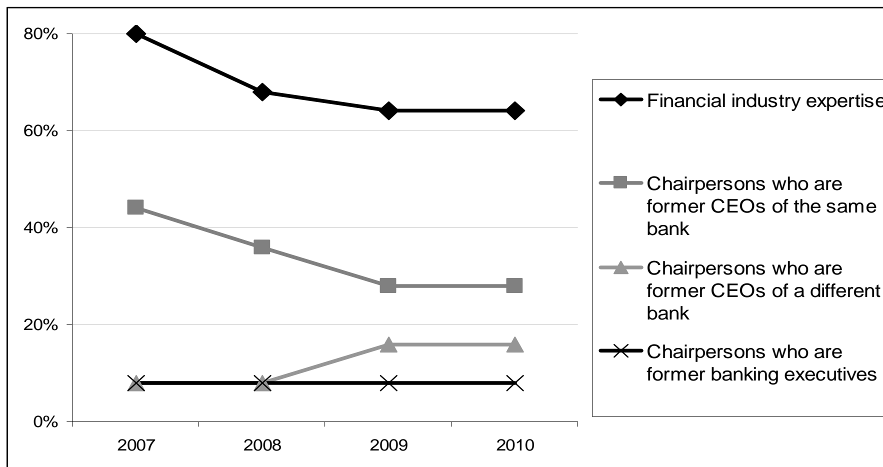
There are a number of requirements for members of the supervisory board of a bank. An absolute requirement is that they have high qualifications, clearly understand their role in the supervision of the bank and are able to assess the matter in a balanced manner. This is the first rule of effective corporate governance in banks, published by the Basel Committee on Banking Supervision (BCBS, 2006, February). It is therefore necessary to ensure that the board of the bank consists of persons with great professionalism[6] (adequate direction of knowledge, skills, commitment, experience), constantly upgrading their skills.

As presented in Figure 1, the percentage of chairs of the board with financial industry expertise within the 25 largest European banks is slowly decreasing (while the overall figure of percentage of non-executive directors with financial industry expertise is increasing, but the average figure is much lower – about 30%; at the same time the maximum percentage is also decreasing). This means almost 2/3 of the chairs of banks boards have previously held

6 For more on professionalism in the functioning of supervisory boards: Jeżak J. (2005).

executive positions in banks or other financial institutions. The frightening fact is that in some boards none of the non-executive directors has financial industry expertise.

Fig. 1 Financial industry expertise of chairs of the board (25 largest European banks)



Source: Nestor Advisors (2010)

Members of the board must be able to spend enough time performing their tasks (which is not limited to participation in the meetings of the board and its committees).[7] It is important that members of the board should perform their duties with engagement, but it is not recommended that they take part in the current (operational) management (BCBS, 2006, February).

It is necessary to keep formal rigorous assessments of the board and its members, and the report of the assessment should be available (some codes of governance are explicitly the requirement for such assessments at least once a year). This is to ensure that the board (and its individual members) fulfils its task due, and it includes the persons characterized by professionalism, meeting the specific requirements of the supervised company.

Another matter of corporate governance, of essential importance, is the membership of the independent persons in the council[8]. The Polish good practice recommends that at least two members of the supervisory board meet the criteria of independence (whatever the overall size of the board[9]). Their participation in the board is to objectify its work, to provide care to the board in the first instance of the fortunes of the company (and not just its owners), as well as a balance between the interests of the dominant shareholders and minority shareholders. Figure

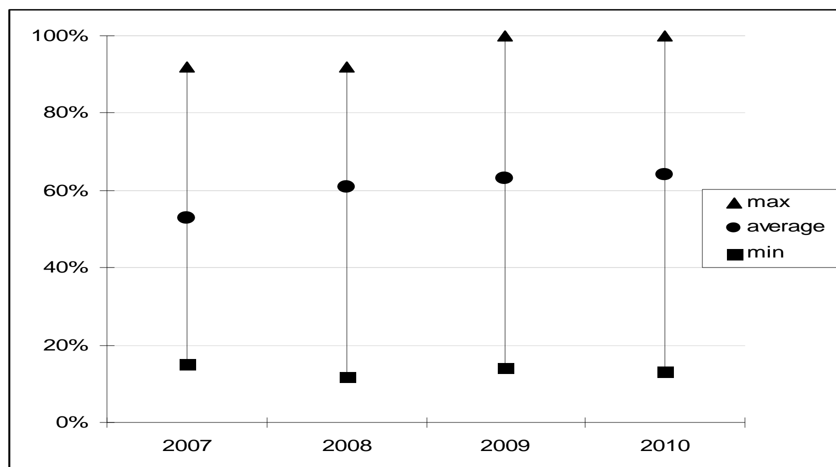
7 Attention is drawn to the fact that the directors should devote their duties related to the supervised company much more time than now. See: Walker (2009).

8 The profile of independent director is for example described in the Commission Recommendation of 15 February 2005.

9 Some codes of corporate governance suggest a percentage of independent board members (eg. the British Combined Code – 50%).

2 illustrates the trends in the independence of non-executive directors in the largest European banks.

Fig. 2 Percentage of independent non-executive directors (25 largest European banks)



Source: Nestor Advisors (2010)

Control of the risk incurred by the bank

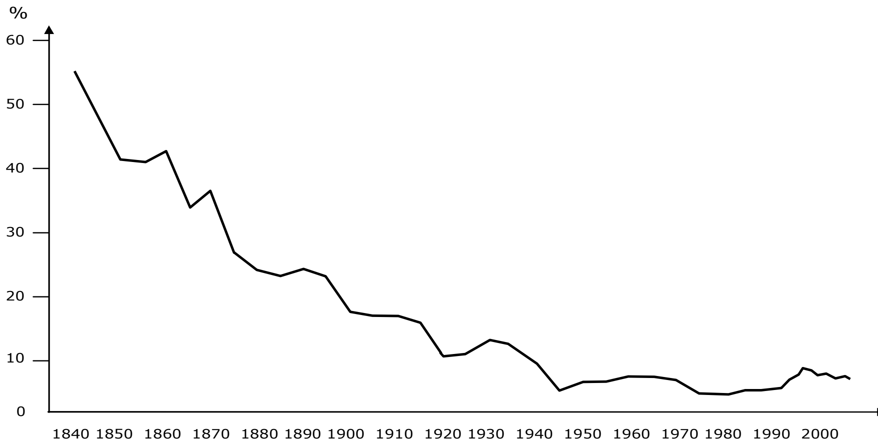
Risk is the inherent feature of bank's activities; bank management is indeed risk management. Proper management of the risks incurred by the bank provides for its survival on the market and financial success. Regulations impose standards limiting the bank risk and requiring adequate equipment in the capital to absorb losses due to materialization of this risk.

In addition, recommendations and standards provide guidance for the banks concerning the main stages of the process of risk management: identification, measurement, control and monitoring. Peculiarities of the development of markets and financial instruments cause that those first are not able to take account of all the details and options, quite quickly become outdated and do not correspond to reality.

Banks led by the desire for profits can easily use the gaps in legislation and expose themselves to risks without incurring regulatory consequences. However, if the bank inadequately calculates its capital needs, and the supervisory bodies are not able to catch it early and discipline the bank to take appropriate action, it could threaten the solvency of that entity and cause its bankruptcy.

Figure 3 pictures the trend in the evolution of the average proportion of equity to assets of U.S. commercial banks during the last 160 years, indicating a dramatic decline in the importance of equity in the financing of the bank. Given that the most important function of capital in banks is the stabilization and loss absorption, this shows the huge growth of risk over the years.

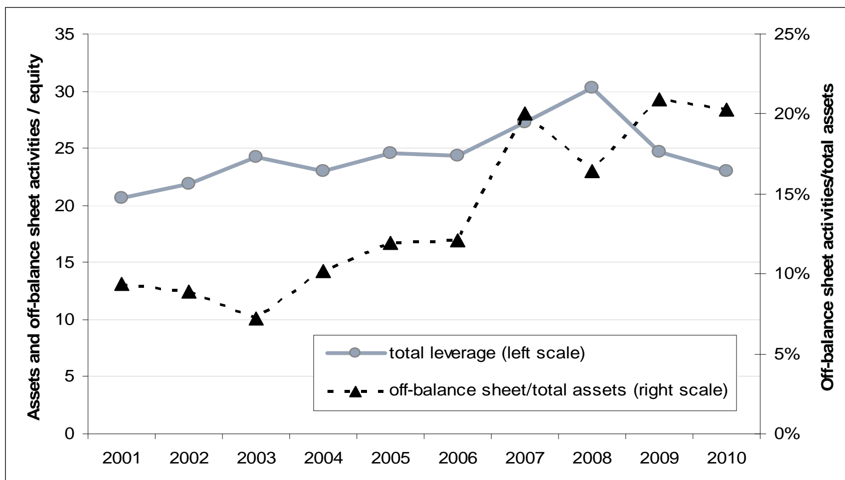
Fig. 3 The average equity/total assets ratio in US commercial banks



Source: based on Tarullo (2008) and Bank of England (2009)

Figure 4 illustrates the recent history – on the example of the largest 100 banks from OECD countries it shows the increase in financial leverage (understood as a relationship of off-balance sheet assets and liabilities to equity) and the growing importance of off-balance sheet items in banks.

Fig. 4 The average leverage ratio and off-balance sheet /total assets ratio in top 100 OECD banks



Source: author's own work based on BankScope database

Both figures document the increased risk generated by the banks; other important indicators showing the same trend are: the growth of loans/deposits ratio, increase in loan loss provisions/net interest ratio (and the worsening of other ratios describing loans quality and the scale of provisioning), the growth of exposures to central banks, etc.

Risk management is a very difficult process; often it is emphasized that it is more art than science. Risk management in banking is all the more difficult as it is magnified by the domino effect (contagion effect). The stability of a bank is influenced by the situation of the other actors of the sector; decline in confidence in one of the banks often results in a decrease in trust in all financial institutions. Ensuring appropriate policies, processes and infrastructure of risk management is therefore fundamental to the bank survival. Effective risk management is based on good corporate governance and rigorous internal control (W. J. McDonough, 2002).

The role of the supervisory board is more important; its task is, among others - monitoring of implementation and adequacy of the operation of the system of management (including risk management) and the establishment of strategic objectives (including an acceptable level of risk). This means determining the optimal level of risk (in the context of the adopted strategy, conditions created by the environment of the bank, current and projected financial situation and their resources, including capital and skills, the available contingency plans) and monitoring of the current risk in relation to that level. It is necessary in this area to cooperate and use the work of external and internal auditors of the bank and the internal control function. Excessive risks taken by banks and the use of complex financial instruments which in fact transfer the risk (and this is often not fully recognized by the buyers of those instruments) were the direct causes of the bankruptcy of many banks and spread of the financial crisis. Supervisory bodies have responded with the proposal to strengthen prudential standards – "Basel III" framework has been adopted, which tightened the definition of capital, introduced counter-cyclical capital buffers and introduced liquidity standards (BCBS 2010, December a; BCBS 2010, December b; BCBS 2011, June)[10].

Currently the guidelines are being formulated, aiming to strengthen the functions of risk management in banks. First of all, it is emphasized that the establishment of the policy management of risk (including the determination of an acceptable level of risk) is one of the main duties of the supervisory board. In banking environment there is full agreement as to the validity of this principle. However in practice it turns out that while the board indeed establishes the policies and priorities for risk management, the risk awareness and risk management awareness are not widespread in the organization (which is read as weak corporate governance)[11], and reports about the risks are not always appropriate or available to the board (G. Kirkpatrick, 2009, September).

10 There are essential changes in capital requirements (including the capital buffers and dynamic provisioning), liquidity risk measurements standards and a system of supervision of financial markets (including the establishment of institutions responsible for the control of systemic risk). For further discussion see: M. Marcinkowska, 2009a and M. Marcinkowska, 2009b.

11 The vast majority of surveyed councils of large European banks only "rather had knowledge" of the risk measurement methodologies (with a small percentage of responses "was very knowledgeable") - Nestor Advisors, 2008.

Among the recommendations there is the suggestion that in (the large listed) banks the risk committee should work[12] regardless of the audit committee. Such a committee would oversee the actual risk exposure of the bank and advise the board on the strategy of risk management. This committee should cooperate on a regular basis with a member of the board of management responsible for risk (Chief Risk Officer) and external experts in the field of analysis and risk assessment.

It is also recommended to the board (or the risk committee) to draw up a report on the risk, which would constitute a part of the annual report of a bank (D.Walker, 2009, November 26).

It is worth noting the excessive confidence in mathematical models for measuring risk. These models are simplified descriptions of reality and are based on many assumptions, which may reduce their effectiveness in predicting future states. Although the risk measurement methods are improved, we cannot rely solely on an analysis of numbers; risk management, management of the bank, must be based on a prudent subjective assessment (the result of the numerical methods yields only the basis for the assessment made by a human being).

The remuneration of bank managers

The task of the supervisory board is to ensure that the system of remuneration of the bank management was consistent with its corporate culture, its long term objectives and strategy and environment control (BCBS, 2006, February). It is difficult to deny the validity of this principle (formulated by BCBS). However, it is the issue of remuneration of the bank management that is indicated as one of the fundamental problems of corporate governance and is pointed out as one of these irregularities which led to the financial crisis.

The level of remuneration in banks has substantially grown in the recent years. The example of average New York City salaries (Figure 5) shows that in the record year 2007 the average pay in securities industry (mainly banks) was over 520% higher than the average for all other private sectors. The bank executives’ pay is growing even faster.

The inadequacy of the mechanisms of corporate governance in this area largely stems from the short time horizon in which results of the companies (including banks) are assessed and from the pressure to generate a high return on equity (which requires banks to generate high profits). Impatience and greed of investors was therefore the key factor provoking banks to more aggressive financial behaviors (the greed of banks and bankers blamed by the media was only an indirect consequence). Not without significance is also the practice of making the managers into owners of their banks (through the payment of wages in the form of stocks or stock options) designed to motivate managements to take a greater care of the owners’ interests; the effect was achieved in multiple ways.

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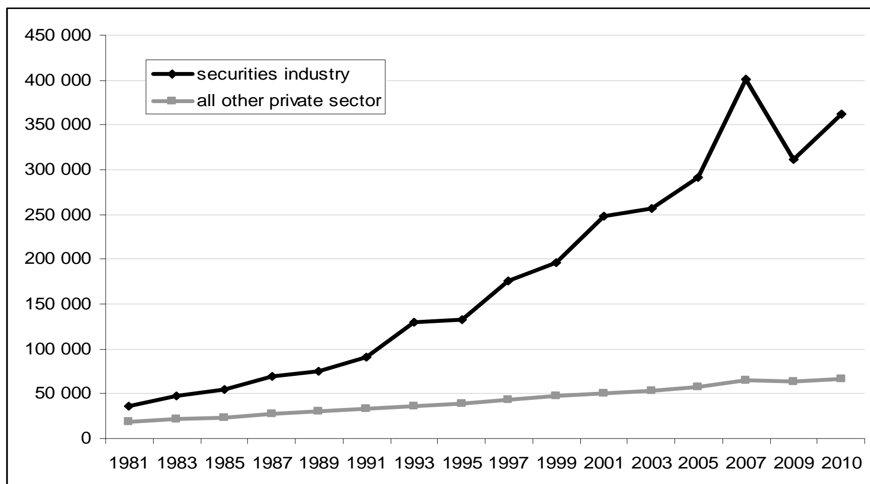
12 Currently there is such a committee in less than half of Europe's largest banks.

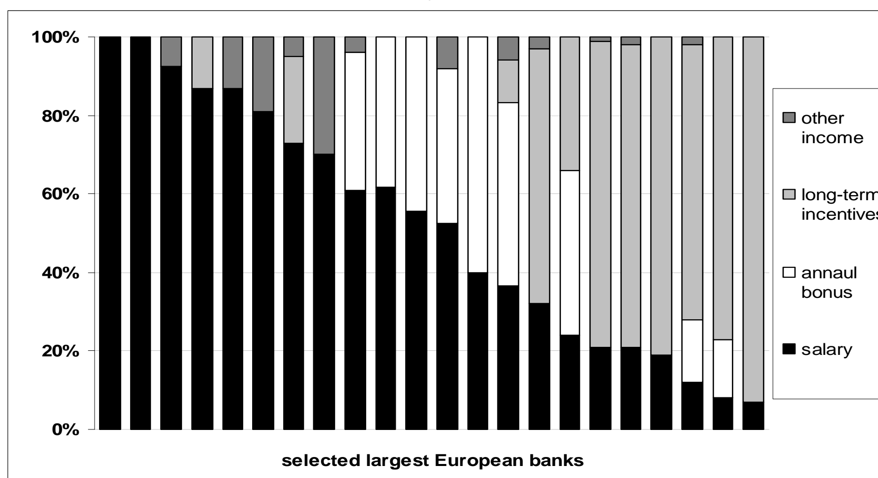
Fig. 5 Average salaries in New York City (US$)



Source: based on Rampell (2011)

The structure of CEOs remuneration can stimulate excessive risk taking – if the bonuses are tight with the short term results (e.g. one year profits or profitability ratios), the managers are willing to concentrate on generating higher returns (even at one-time events) and tend to neglect the risk. Although the total remuneration of bank CEOs has been decreasing since the financial crisis, the short term bonuses still play an important role in many banks (see Figure 6).

Fig. 6. Structure of remuneration of largest European banks' CEOs (fiscal year 2009)



Source: based on Nestor Advisors (2010)

The boards of the banks – willing to generate high profits in the shortest possible time – take excessive risks. Studies have confirmed that excessive risk taking (and treating risk more as a possibility of achieving profits than losses) is stimulated by an application of higher premiums

and financial objectives for the management (K. Bechmann, J. Raaballe, 2009, September and F. Harman, S. Slapnicar, 2007).

Therefore, some recommendations concerning principles for remuneration of the managers are formulated, constituting that[13]:

- there is a need to link items to incentive targets, the owners and the long-term profitability of the bank, while taking into account the level of risk and cost of capital;
- components of the special incentive arrangements should not lead to bearing risk exceeding the acceptable level,
- payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit[14];
- bonuses should include an element reflecting the impact of the results of the business unit for a total value of the related business groups and entire organizations;
- bonuses should include an element reflecting the accumulated results of achievement in the field of risk management and other overall objectives;
- severance payment should take into account the results achieved for owners in the horizon of time;
- strategy, principles and objectives of the incentive pay should be transparent for owners.

The broader recommendations relating to the whole system of remuneration in the bank are raised. The remuneration committee should be familiar with the conditions of employment and remuneration applied by the bank, to ensure that it is implementing a consistent approach to remuneration of all staff. It is recommended that the supervision of wage policy exercised by the committee of the council is extended to all the best paid employees (and that the evaluation of the relationship with the objectives concerning the results and risk is taken into account); it is also suggested that large quoted banks disclose the remuneration of such employees (as is the case for members of management). It is also stipulated that the banks have a deferred payment of the premium that includes a mechanism for corrections of risks so as to provide for sustainable results. It is necessary to ensure that the system and structure of remuneration does not encourage the wrong bank exposure to risk – remuneration policy must be consistent with effective risk management (A. Turner, 2009, March, D.Walker, 2009, November 26)[15]. The remuneration policy should be transparent inside the bank and disclosed outside (CEBS, 2009, April 20).

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13 IIF (2008, July). Final report to the IIF Committee on Market Best Practices: Principles Conduct and Best Practice Recommendations, Washington.

14 This recommendation is implemented the least; some institutions do not plan to include it at all (IIF, 2009, March).

15 Those recommendations are already included in guidelines of some regulators, e.g.: FSA (2009, August) and EU (Commission Recommendation of 30 April 2009).

Bank transparency

Bank transparency has several aspects. The most important is the question of transparency in the activities of the bank and its management and the issue of transparency (and understandability) of reports on the activities of the bank and its results. The question of transparency of the activities of the bank is to a considerable extent linked with its established organizational structure. If complex structures (e.g. enhanced capital group and special purpose entities — SPV) are implemented, the responsibility is blurred, transferring income, cost and risk is easier. Similar effects can be caused by an implementation of matrix structures in related banks. This limits the powers of the management structure for a subsidiary bank (decisions are taken by the heads of the divisions at the central level, this means full dependence on the owner) and makes it more difficult for an overall evaluation of the risk of individual participants of such a holding company.

Non-transparent structures give rise to additional risk (financial, legal, or reputation) and impede adequate control and supervision (in particular with regard to separated and outsourced areas and matrix dependence). The bank therefore strives to ensure clarity of structures and links, to gain a complete picture of the results and the risks incurred by the bank (as a whole and the individual divisions/units).

The second issue of the transparency of a bank is openness and transparency of information about its financial health. This is a basic condition for the functioning of effective market discipline, which is the private monitoring carried out by the purchasers of the securities issued by the bank (as well as by clients). Market discipline means that the entity has stakeholders from the private sector, who may suffer a financial loss as a result of the decision of that body, and who can "discipline" bank or affect its activities (FRS Study Group on Disclosure, 2000, March).

The existence of an effective market discipline is dependent on several factors, the most important are: the existence of well-developed securities markets, bank issuance of subordinate debt securities or other hybrid securities in the market, access to reliable, complete, up-to-date information about the profile of risk borne by the bank (and proper understanding of the information provided by the bank), the presence of response to market signals[16].

Regulators - recognizing the potential role of the bank private monitoring - strengthen this pillar of surveillance by establishing more stringent information requirements on banks. In developed economies, there is indeed evidence of the effectiveness of the discipline of the market in the risk assessment of the bank (and motivate banks to limit the risk undertaken).

However, during the last financial crisis, the market discipline has suffered a defeat (A. Turner, 2009, March). The prices of financial instruments issued by banks (in particular shares

16 More about market discipline: K. Jackowicz (2004).

and CDSs) did not reflect the risks incurred by these institutions and did not announce upcoming problems (and their scale). Where to find the causes? The answer lies in several areas (Marcinkowska, 2008):

- First, the criticism is aimed to the accounting standards (whatever their orientation: principle-based – as in IFRS or rules-based – as in US GAAP); however, it should be acknowledged that the legislation in certain areas (such as securitization) does not prevent the hidden risks of investment; the issue of accounting for financial instruments is also controversial;
- banks ignored information requirements, intentionally obscuring the facts picturing their financial situation (in particular the nature and level of risks incurred);
- the independent entities having assessments of banks and issuing of securities under the securitisation failed (auditors and rating agencies[17]);
- investors were not aware of the risks incurred, in part due to the aforementioned reasons, but partly these losses were the result of overly aggressive investment policies and a lack of the good practices of risk management.

In many cases, the regulatory gaps have already been closed, but it should be noted that particularly in this area good regulations do not ensure success. This is dependent on the integrity and accuracy of all the parties involved in the process (especially the persons responsible for the preparation and verification of reports, but also their customers –persons taking the decisions on the basis of those statements).

Banks' shareholders

Inefficiencies in corporate governance are often associated with the specific structures and organizational or capital links (where the banks are part of large conglomerates, especially where members of a group mutually own their shares). The financial dependence (e.g. granting loans or buying bonds) may be based on inadequate risk analysis, which consequently increases the risk for the whole group.

In relation to the subprime crisis, one can indicate that an important reason for its occurrence was the fragmentation of the shareholders of financial institutions (which blurs the responsibility of the owners for the fortunes of the company and increases the strength of the management executives), as well as the presence of the cross-dependencies (which has enlarged and spread the crisis) and aggressive, geared for quick profits, investment policy of funds and other – usually short-term – investors (M.Marcinkowska, 2009a).

Given the large – sometimes negative – role of institutional investors, special recommendations for this specific group of shareholders are formulated, relating to the responsibility, integrity, diligence, dignity, fair competition, activities for the development of

17 After the subprime crisis, regulations concerning the activities of credit rating agencies were introduced.

the market ant preventing conflicts of interest. Many of these recommendations were also included in the cited *Walker Review*, as rightly noted that the activities and results of the banks are affected – directly or indirectly, actively or passively – by initiatives and decisions taken by the owners. The responsibilities of both the board and the institutional investors are set out, as well as the need for cooperation and engaged cooperation.

During the recent financial crisis many banks were nationalized. Although in a short term this was seen as a good solution to help the troubled banks (especially given the scale of problems and the potential threat to the financial sector stability), it should be noted that in the longer term state ownership should be repealed. Research supports bank privatization – private-owned banks are more efficient (J. Williams, N. Nguyen, 2005).

Enhancing corporate governance in banks – what has been done so far

These issues have become the subject of numerous decision-making bodies, part of the above issues have been addressed in the new regulations and guidelines, in relation to many other processes creating new legislation is still in progress.

Among the global guidelines further initiatives are set by the Basel Committee. Banking Supervision should be indicated. First of all, sectoral "good practices" must be indicated, taking into account the specificities of the banks. General rules intended to improve corporate governance in banks were updated by BCBS in October 2010. The current version of the document contains 14 rules in 6 areas (BCBS, 2010, October):

- supervisory board practices,
- senior management,
- risk management and internal control,
- compensation policy,
- complex or opaque corporate structures,
- disclosure of information and transparency.

An extension of these documents is guidelines for the internal audit function in banks (BCBS, 2011, December) that formulate 20 rules relating to the issue: supervisory expectations relative to the internal audit function, a function for internal audit of the institution of the supervisory board, the supervisory assessment of the internal audit function.

Also the issue of remuneration of the top executives of banks was included in the Basel guidelines – the document formulates principles for remuneration and methodology for standards assessment (BCBS, 2010, January).

In addition, the ongoing work must be indicated: some new regulations have already been developed and implemented.

As soon as in February 2009, the Group of experts chaired by Jacques de Larosière recommended creating a European system of financial supervision (The de Larosière Group

Report, 2009). In September 2009 a new supervisory architecture was proposed (which has been operating since January 2011): the European System of Financial Supervisors (ESFS), consisting of regulators operating in the EU: banks (European Banking Authority), insurance companies and pension funds (European Insurance and Occupational Pensions Authority) and stock exchanges (European Securities and Markets Authority); an additional element of this design is the European Systemic Risk Board[18].

Among the new regulations first the initiative of the European Union should be mentioned: in June 2010, the EU published a "green paper", referring to the issue of corporate governance in banks and their policies of incentive compensation of management (European Commission, 2010, June 2 b). This document summarizes areas of inefficiency and failures of corporate governance in banks (they are included in the list mentioned above), indicates the already taken pre-legislative initiatives, and for consultation - options for further measures. They concern, among others: accountability, independence and competence of the supervisory board, strengthening risk management and status of the chief risk officer, the introduction of a requirement for reporting by the auditor to the supervisory board and banking supervisory institution, information on the observed significant risk, strengthening of banking supervision, broader engagement of bank shareholders and exercise of effective control, as well as remuneration issues of management and a conflict of interests. The Green Paper is accompanied by a working document presenting good practices in the areas: the supervisory board, risk management, owners, supervisors and external auditors (European Commission, 2010, June 2 a).

Earlier - already in 2009 - the Commission issued a recommendation on remuneration policies in the financial sector (Commission Recommendation of 30 April 2009). The general requirement is acceptance by banks of such remuneration policy which will promote sound and effective risk management and will not encourage excessive risk, and at the same time, will support the implementation of business strategy and reduce conflict of interests. In particular, specific guidance with regard to policy formulation of the variable component of remuneration is provided.

In addition, the European Commission has developed new arrangements, the essential purpose of which is to increase the effectiveness of risk management in European credit institutions, which should help prevent excessive risk taking by individual banks, and as a result of cumulating excessive risk in the financial system. The new legal framework has three operational objectives (European Commission, 2011, July 20):

- increasing the effectiveness of the board of supervision over risk;
- raising the status of the risk management function; and
- ensuring effective monitoring of the risk management by supervisory authorities.

18 See more: http://ec.europa.eu/internal_market/finances/committees/index_en.htm.

Upon the wave of criticism against the regulations relating to capital adequacy there was the revision of the guidelines (the "Basel II"), the BCBS developed some requirements and introduced the additional standards in this area – the "Basel III" (BCBS, 2010, December a, BCBS, 2010, December b, BCBS, 2011, June).

Basel guidelines are the basis for the creation or revision of the regulations under the European Union. The European Banking Authority published the guidelines on the management system of the institution and the internal control in September 2011 (EBA, 2011, September).

Conclusion

The scale irregularities found in banks and financial markets that led to the financial crisis have brought up the need for in-depth analysis of all aspects of their operation, in particular the efficiency of corporate governance. The result was an indication of a number of shortcomings; sometimes they resulted from inadequacy or insufficiency of the provisions, other times from human imperfections. Currently, regulatory and supervisory institutions and environmental bodies prepare proposals for reforms to strengthen the mechanisms of corporate governance.

The analysis of main failures of corporate governance in banks suggests that in order to repair and strengthen the system:

- banks ought to reduce their risk exposure significantly, build a stronger capital base; banks should concentrate on typical banking activities and reduce the scale of other operations (especially investment activities); the good standards of balance-sheet adequacy (ALM) should be restored (e.g. loans-deposits relationship, assets and liabilities maturity match, leverage scale, etc.);
- the scale and scope of banking activities should be diminished, as the current level of financialization is excessive and potentially dangerous for the whole economy; special attention should be paid to systemic risk: systemically important banks ought to have more strict capital requirements (additional capital buffer); the capital and contractual relationships between financial institutions should be monitored and if the linkages would become too strong and/or concentrated, supervisors should be allowed to interfere in these relationships;
- bank directors (both: executive and non-executive) should bear personal responsibility for banks' activities and risk;
- banks' executives remuneration should be linked to performance and risk exposure; there should be an obligation to use part of their salary deferred: a) not to motivate to generate short-term profits and increase the risk and b) make the bonuses contingent on long-term sustainable outcomes;
- non-executive directors engagement should be stronger – they should devote more time and commitment to perform their oversight function; nomination of supervisory board members should be approved by the supervisors (as it is in case of management board

members); the role of independent board members should be strengthened, board members should be required to have proper knowledge and experience (including the financial expertise);

- regulators and market supervisors should strengthen banks' transparency allowing for the effective market discipline; professional bodies should promote best practice in disclosure and motivate banks to publish more informative reports;
- the accountability of external and internal auditors should be stronger and they should be obliged to report any observed non-compliance to supervisors; the auditors should be subject to mandatory rotation and should be banned from performing services for one client of other services beyond the audit of financial statements;
- "comply or explain" rule used in corporate governance area, being a sort of a "soft law" should be strengthened by the monitoring function performed by financial market and the supervisor should verify whether the disclosed information is reliable and sufficient;
- in particularly important areas in which banks persistently do not comply with corporate governance best practices, supervision should make formally binding rules; one should keep in mind, however, that this should not lead to excessive growth of regulation because it would harm the competition (overly restrictive regulation can lead to inefficient provision or supply of financial services).

Without doubt, the greatest responsibility for the excessive risks is borne by the banks themselves – their management and supervisory directors. However, it is worth noting that other stakeholders also contributed to the crisis: supervisors and regulators, participants in financial markets (including investors), auditors and rating agencies, and clients. Obviously, legal, economic and ethical issues differentiate the degree of responsibility and the magnitude (severity) of the effects of the acts or omissions of several operators.

Regardless of the regulatory changes, it is necessary to emphasize the importance of accountability of all banks' stakeholders. One must realize that there are no perfect regulations, and even the best legal standards do not ensure success. This is because it is the attitude and actions of human beings; honesty and sense of responsibility of all stakeholders of the bank are necessary.

As mentioned, governance – particularly in the banking sector – should ensure the care of the well-being of all its stakeholders. This corporate fairness, transparency and accountability must be symmetric.

As it is nowadays emphasized, there is also no doubt that the basic element of the improved governance of the financial market should be ethics (EC, 2010). It is unrealistic to expect that the supervision and private monitoring of complex financial markets and institutions may be based solely on regulations, but this neither means that the state may exempt from these processes. An effective regulatory regime must be based on a desire to keep high management standards and values as part of banks' corporate culture (R. Tomasic, 2011).

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DOI: 10.5817/FAI2012-2-4