“CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS”

Four papers by

Spyros G. Stavrinakis
Christian Harm
David T. Llewellyn
Bridget Gandy et al.

Introduction
by Morten Balling and George Kyriacou

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By *Spyros G. Stavrinakis, Christian Harm, David T. Llewellyn, Bridget Gandy, Peter Shaw, Peter Tebbutt and Mark Young*

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Introduction

By Morten Balling and George Kyriacou

On 29th – 30th March 2007, SUERF and the Central Bank of Cyprus jointly organized a Seminar: *Corporate Governance in Financial Institutions.* The papers in the present publication are based on a sample of the presentations at the Seminar. Together, the papers illuminate a number of key issues in corporate governance in a variety of financial firms.

In the first paper based on a keynote address, *Spyros G. Stavrinakis,* Central Bank of Cyprus gives an overview of the legal framework for corporate governance in financial institutions in Cyprus. According to a Central Bank Directive issued in 2006, implementation of corporate governance principles is mandatory for all banks incorporated in Cyprus and their overseas branches and for some Cyprus branches of foreign banks domiciled outside the European Economic Area. Banks are obliged to have a robust internal governance framework, consistent lines of reporting and effective risk identification, management, monitoring and reporting procedures for all the risks to which credit institutions are actually or potentially exposed. The board of directors should take the lead in establishing and approving ethical standards and corporate values for itself and for the bank's senior executive management. Potential conflicts of interest should be identified, prevented or appropriately managed. Each bank should maintain a compliance function that monitors compliance with rules, regulations and policies. Clear lines of responsibility and accountability should be set and enforced. New members of the board of directors as well as the senior executive managers of banks have to be vetted and approved by the Central Bank of Cyprus for their "fitness and properness." In order to ensure transparency concerning the implementation of the principles, each bank's corporate governance framework should be disclosed in the bank's annual report and on its public website.

In the second paper by *Christian Harm,* University of Muenster, "The Governance of the Banking Firm" the author builds on the literatures on corporate governance and financial regulation. In relation to governance of financial institutions, agency theory has both merits and shortcomings. It provides good explanations in many delegation situations but it has severe

difficulties in dealing with institutions with several stakeholders and complex objective functions for the management. Firms guided by shareholder value may work more effectively than firms guided by stakeholder cacophony. Depositors are important stakeholders in banks. Since they are typically incapable of managing the supervision of their claims on the bank, they rely on regulators to do it for them. Remuneration systems for bank managers should provide proper incentives. According to the author, incentives should be structured such as to reward particular strategic achievements. Banks can apply executive stock option plans, but should confine options to a secondary place behind other long-term incentives based on success criteria that further shareholder interests without compromising the regulatory mission. Such an incentive framework tends, however, to be very complex so that the general ambiguities associated with the concept of governance could imply that in the banking firm, selecting managers with a proper intrinsic motivation may be superior to defining complex remuneration programs.

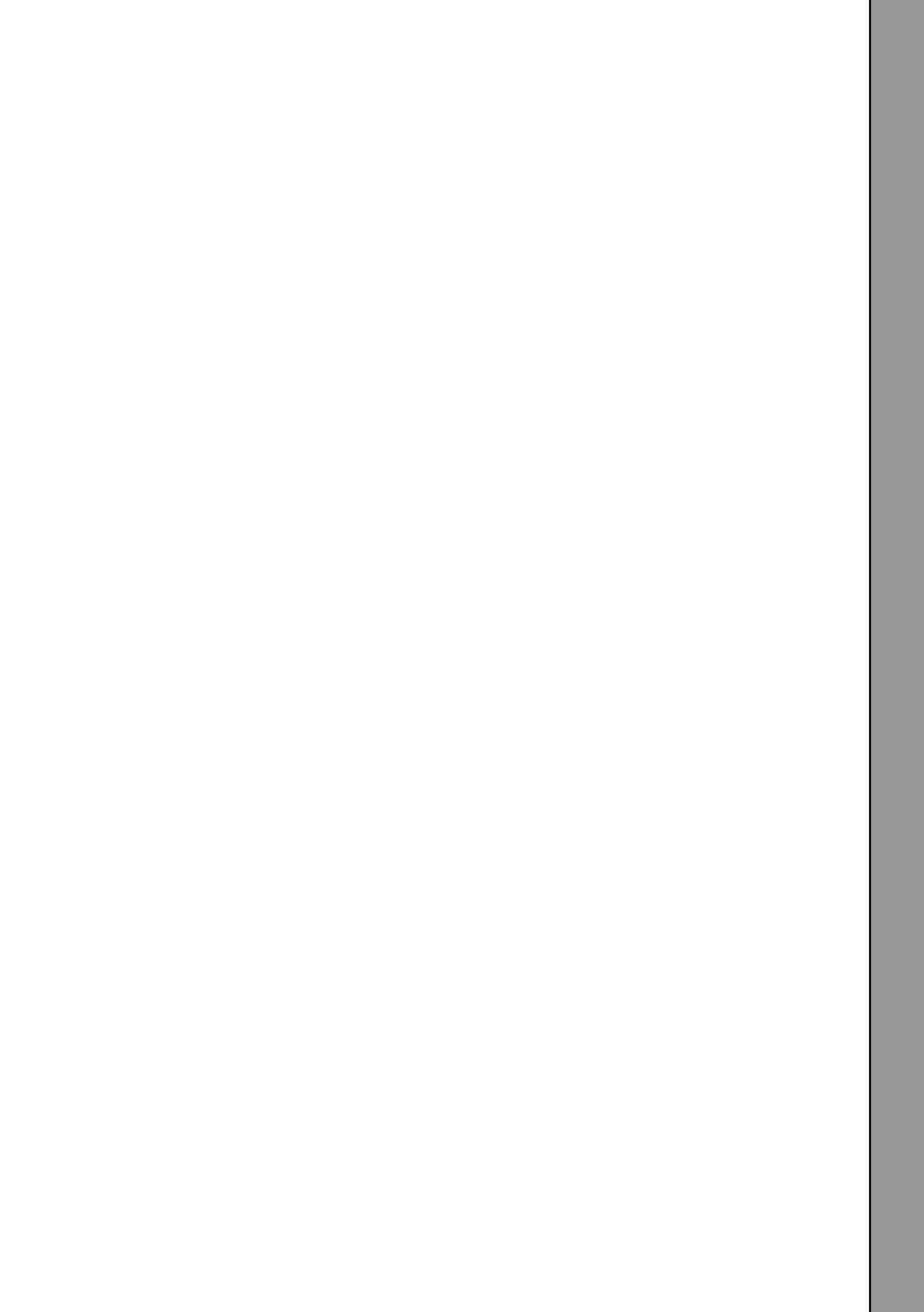
In the third paper "Corporate Governance Issues in Non-Shareholder Value Financial Institutions: A Case Study of Mutual Building Societies in the UK", *David T. Llewellyn,* Loughborough University, focuses on corporate governance in non-incorporated financial firms. The author describes the relevant stakeholders and the nature of agency problems in different types of financial firms. He compares monitoring mechanisms, incentives, abilities and feasibilities of managers and members of mutuals. Mutuality raises specific corporate governance issues: Corporate governance is less clearly defined because the firm's objectives are less clearly defined. Conflicts of interest between managers and owners are less easily identified and it is more difficult to create management incentives. The almost exclusive source of capital is retained profits and each member has a non-exclusive and non-marketable claim to residual net worth. Voting rights are typically not proportional to the size of the ownership stake. There is no market in ownership claims and therefore no effective market in corporate control. Consequently, there is ample scope for mutuals to be inefficient. There is, however, no evidence that the efficiency and performance of mutuals are poorer that that of incorporated financial firms.

In the fourth paper "Corporate Governance in Emerging Market Banks", *Bridget Gandy,* Fitch Ratings Ltd., and her co-authors from the rating agency look at the framework for corporate governance of banks in a sample of emerging market countries. Since the crisis in the late 1990s in Latin America and Asia, there has been a marked improvement in corporate governance of financial institutions in the regions under observation. Many countries have

taken legal steps to develop functioning market economies with a view to the need to satisfy the demands of international capital markets. Several banks have listed their shares on stock exchanges in developed markets and foreign bank ownership and involvement in local banking systems have increased. In Central and Eastern Europe, countries' desire for EU-accession has impacted on the development of their corporate governance systems. At the individual bank level, Fitch Ratings looks at bank board independence and quality, oversight and the importance of related party transactions, the integrity of the audit process, acceptability of executive and director remuneration, ownership structures and transparency. In evaluating the quality of governance at the country level, the authors apply a three-pillar approach in line with Montesquieu: Powers and responsibilities need to be separated between a representative legislature, a competent and accountable executive branch and a fair and independent judiciary. The paper contains an interesting table in which a number of key regulatory initiatives in a sample of emerging market countries are compared. The authors point out that large scale privatizations have reduced the importance of state-owned banks in many countries. There are, however, still several examples with complex holding structures involving banks with potential negative implications for corporate governance quality and problems with related party transactions. Acquisitions by foreign banks with developed corporate governance standards have generally had a positive impact and also listing of bank shares on foreign stock exchanges with tough disclosure and transparency requirements have contributed positively to the quality of corporate governance in emerging market banks.

Read together, the four papers give a good overview of the development of corporate governance practices and remaining problems in financial institutions of different types and with domicile in different countries.

The Editors



Keynote Address

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Ladies and Gentlemen,

The Central Bank of Cyprus is delighted for being given the opportunity to jointly organise with SUERF today's and tomorrow's seminar on "Corporate Governance in Financial Institutions". This opportunity is indeed unique for three reasons: Firstly, not very often representatives of Cypriot financial institutions can participate in seminars, in their own country, organised by internationally acknowledged fora and associations such as SUERF. Today's and tomorrow's seminar is also unique because it almost coincides with the implementation of the European Union's new Capital Requirements Directive, a substantial component of which are the enhanced corporate governance requirements applicable to credit institutions and, lastly, because it is organised on the eve of a very important decision which is going to be taken by the European Commission and the European Central Bank on Cyprus's application to join the euro area, a decision which, from our country's point of view, will be a historical milestone in its policy towards a full European integration.

Being a Central Banker, I am going to confine my observations, in this address, to my country's commercial banking sector which falls under the supervisory responsibility of the Central Bank of Cyprus. This sector comprises 40 credit institutions which, in terms of balance sheet footing, it is estimated to represent as at the end of 2006, over 70% of the broad financial sector i.e. commercial banks, cooperative credit societies, investment firms and insurance firms. Two rather unique features which characterise Cyprus's commercial credit sector are, firstly, the fact that until the end of 2005 there was a distinct "offshore" or international sub-sector which was "ring fenced" from the rest of the banking sector in that its members were dealing primarily in currencies other than the Cyprus pound and with non-residents of Cyprus and, as a consequence, they were taxed at a "preferential" rate. This special fiscal regime came to an end on 1st January, 2006, in line with the government's commitment towards the OECD and its obligations emanating from the EU accession process; and, the second unique feature is, the existence of a substantial cooperative credit sector which, in terms of loans, represents 22% of total loans and, in terms of deposits, 21% of total deposits as at the end of 2006. There is a separate supervisory authority for the cooperative credit sector, the Cooperative Societies' Supervision and Development Authority, whose representatives are here, at today's event, and whom we very much welcome.

The implementation of corporate governance principles has become mandatory on 1st January, 2007, for all banks incorporated in Cyprus and their overseas branches as well as for those Cyprus branches of foreign banks incorporated outside the European Economic Area which, in the opinion of the Central Bank, are not subject to a supervisory framework, by their home banking supervisory authorities, equivalent to that exercised by the Central Bank of Cyprus. The relevant Central Bank Directive which has put into effect the corporate governance principles, in relation to the banking sector, was actually issued in the middle of 2006, following a round of consultations with the Chairmen and Senior Executive Managers of all banks incorporated in Cyprus who were, thus, given the opportunity to submit comments, observations as well as suggestions on its contents. The title of the relevant Directive is “A Framework of Principles of Operation and Criteria of Assessment of Banks’ Organisational Structure, Internal Governance and Internal Control Systems” and it was implemented on 1st January, 2007, simultaneously with the European Union’s new Capital Requirements Directive. Article 22 of the European Directive provides that each credit institution should have a robust internal governance framework which should include a clear organisational structure with clear and consistent lines of reporting and effective risk identification, management, monitoring and reporting procedures for all the risks to which credit institutions are actually or potentially exposed to as well as satisfactory internal control mechanisms, including suitable administrative and accounting procedures.

It should be noted, nevertheless, that four commercial banks which are public companies listed on the Cyprus Stock Exchange were long before the above date subject to a voluntary Code of Corporate Governance applicable to all listed companies.

The said Central Bank Directive incorporates a number of best corporate governance principles which should be followed by all banks and which are considered to be key elements for every internal governance procedure. The Boards of Directors of banks are expected to fully implement these basic principles, having regard to the nature, size and complexity of operations of their individual institution.

Let us remind ourselves of these principles.

First of all, the Board of Directors of a bank should take the lead in establishing and approving ethical standards and corporate values for itself and the bank’s senior executive management. Such standards should, in

particular, address corruption and other unethical or illegal behaviour in the bank's internal and external activities.

A very important element of such corporate values is the timely and frank discussion of problems, through a system which encourages employees to be able to freely communicate concerns, if necessary in an anonymous manner, about any possible illegal or unethical practices, without fear of reprisal, to the Board of Directors or the Audit Committee. It is the Board of Director's duty to appropriately protect employees who report any such illegal, unethical or questionable practices from any direct or indirect internal disciplinary action.

Another duty of the Board of Directors is to ensure that the senior executive management and employees in general, implement policies for identifying, preventing or appropriately managing as well as disclosing potential conflicts of interest which may arise as a result of the various activities and roles of the bank. In particular, potential conflicts of interest between the personal interest of directors or senior executive managers and that of the bank or its customers should be identified and either be prevented or managed and, appropriately, disclosed.

The Board of a bank should also ensure that the senior executive management implements appropriate strategic policies and procedures designed to promote professional behaviour and integrity. Any activities and relationships which diminish the quality of corporate governance should be prohibited or, appropriately, limited.

It is also the responsibility of the Board to ensure that the bank maintains a compliance function that routinely monitors compliance with rules, regulations and policies to which the bank is subject and ensure, at the same time, that any deviations are reported to the senior executive management and, if appropriate, to the Board of Directors itself.

Another important corporate governance principle embodied in the Central Bank's Directive is for the Board of Directors of a bank to set and enforce its own clear lines of responsibility and accountability throughout the bank. The Board is also responsible for overseeing the senior executive managements' actions and consistency with the Board's policies. In its turn, the senior executive management is responsible for delegating responsibilities to the staff and establishing a management structure and hierarchy that promotes accountability.

It is, needless to say, necessary if corporate governance is to properly function within a bank, for the Members of the Board to be qualified for their positions, have a clear understanding of their role in corporate governance matters and be able to exercise a sound and an independent judgement in running the affairs of the bank. It is for the above reason that both the new members of Boards of Directors as well as the senior executive managers of banks have to be vetted and approved by the Central Bank of Cyprus for their "fitness and properness", in accordance with the provisions of the Banking Law and a separate Directive issued by the Central Bank thereunder.

In discharging its duty of establishing and maintaining a sound system of internal controls for the purpose of safeguarding the shareholders' interests and the bank's assets in general, the Board is ultimately responsible for the operations and financial soundness of the bank. In particular, the Board of Directors and each one of its members individually will be enhancing the corporate governance of their bank if , among other, they fully understand their oversight role as well as their fiduciary duties towards the bank and its shareholders, avoid conflicts of interest, approve the bank's overall risk policy and risk management procedures, periodically assess the effectiveness of their own corporate governance practices, select, monitor and, where necessary, transfer key executives and ensure that the bank has an appropriate plan for executive succession. The Board and its individual members will also be strengthening the bank's overall corporate governance by promoting bank safety and soundness, understanding the regulatory environment and ensuring that the bank maintains a productive relationship with its supervisory and regulatory authorities.

All the above high expectations, indeed requirements, presuppose that the Board is able to exercise its judgement independent of any internal, external, political or other outside interest. Difficult as it may sound, the Board of Directors has a fiducially duty not only to protect the bank from any illegal actions but also from any unethical influences of principal shareholders that may be detrimental or not be in the best interests of the bank and its shareholders.

Family–owned or state–owned banks are particularly vulnerable because their controlling shareholders have considerable powers to appoint members of the Board of Directors. Under such circumstances both the Board and the banks' senior executive management have a fiducially duty to all the bank's stakeholders which include minority shareholders, depositors as well as supervisory authorities. Needless to say that in such cases controlling

shareholders should not be involved in the day to day management of the bank and fully respect the independence of the Board of Directors.

The Board of a bank should also fully and effectively utilise the work of both external and internal auditors as basic contributors towards a sound internal governance. The Board should recognise the importance and role of the audit function by communicating their importance throughout the bank and by fully utilising the findings of external and internal auditors for the purpose of enhancing the overall internal governance process. A specific recommendation made in the Central Bank Directive is that, at least annually, its non–executive and independent members should meet the external auditor and the heads of the internal audit, compliance and legal units, in the absence of the bank's senior executive management. Such meetings enable the Board to better oversee the management's implementation of the Board's policies and ensure that the bank's policies are in line with the agreed risk parameters. The work of the external auditors serves also as an independent check on the management information which the senior executive management passes on to the Board.

Another area where the role of the Board is very important, as far as corporate governance is concerned, is the determination of the compensation of its own Members, senior executive management and other key personnel in line with the bank's culture, control environment, long-term business objectives and strategy. Such remuneration policies should of course be handled by the Compensation Committee of the Board composed wholly or by a majority of non-executive and independent directors.

Boards of Directors should also understand the bank's operations including, in particular, the activities which are carried out in certain jurisdictions or through particular structures, having full regard to all financial, legal and, in particular, reputational risks that such operations may entail. The Board should ensure that any such structures and activities fully comply with the relevant Central Bank regulations, particularly those relating to the combating of money laundering and the financing of terrorism. Equally important for the Board of Directors is to ensure that the senior executive management of the bank follows clear "know your customer" and "know your structure" policies regarding the conduct of activities, on behalf of customers or when acting as agents or trustees or in certain overseas jurisdictions that, possibly, impair transparency. Cyprus's role as a regional financial centre is particularly relevant to the above requirements.

For corporate governance to be effective it must be conducted in a transparent manner. It is, therefore, desirable that certain areas such as the Board of Directors and senior executive management structures, the bank's basic organisational structure, the bank's incentive structure such as remuneration policies, executive compensation, bonuses, etc, as well as the bank's code of ethics are disclosed in the bank's Annual Report as well as, on an ongoing basis, on the bank's public website.

Let me now turn to another important element of corporate governance which is the "fitness and properness" of persons to be appointed on the Board of Directors of a bank. There are specific provisions in Cyprus's Banking Law which describe the basic criteria of "fitness and properness" applicable to the director of a bank and a detailed Directive has also been issued by the Central Bank on the subject. What is important, however, is not only to appoint the right persons to the Board of Directors but also to ensure that such persons and, in particular, the Chairmen and, in their absence, the Vice-Chairmen, play a pivotal role in creating the conditions for overall Board and individual director effectiveness, both inside and outside the Boardroom. The Central Bank's Directive is quite detailed on this matter because it sets out the responsibilities of the Chairman which, inter-alia, include the running of the Board and the setting of its agenda, which should take full account of the concerns of all Board members and be forward looking, ensuring that the members of the Board receive up to date and accurate information to enable them to take sound decisions, ensuring effective communication with the bank's shareholders, ensuring that sufficient time is allowed for the discussion of complex issues, this being particularly important for non-executive directors and identifying the training and development needs of individual and, in particular, new directors.

Equally important, in this context, is the role of non-executive directors and, especially, that of non-executive and independent directors. The non-executive members of the Board are expected to play a leading role in transpiring the appropriate business ethos among their fellow Directors and the senior executive management and in contributing to the setting of the bank's strategic targets as well as assess the performance of the bank's senior executive management.

Non-executive directors should also ensure that the bank's obligations towards its shareholders and other stakeholders are understood and met. They should, in addition, ensure that the bank's internal systems of risk management are robust and be responsible for the remuneration, appointment

and, where necessary, the succession of executive directors. Needless to say that for non-executive directors to be effective, they must be very well-informed about the bank's internal as well as external environment.

The role of a non-executive and independent director is even more important, from a corporate governance point of view, because an effective non-executive and independent director, in addition to discharging the special duties of a non-executive director, should maintain, in all circumstances, his independence of analysis and decision making and clearly express his opposition in the event that he finds that a decision of the Board may harm the bank, its shareholders and other stakeholders.

It is the Board's duty to appoint the non-executive and independent directors and, consequently, regardless of the Central Bank's powers in this area, it should ensure that the prospective appointees are really independent in character and in judgement and that there have been no relationships or circumstances that call into question the desired independence. Such circumstances are listed, in detail, in the Central Bank's Directive and include: past employment by the bank or the group, a material business relationship with the bank, the receipt of any remuneration from the bank apart from the normal directors fees, close family ties with any of the bank's external advisers, consultants, auditors, other directors or senior executive managers and service on the Board for more than nine years.

The non-executive and independent directors serve also as a direct link, through one of their senior members especially appointed for this purpose, with the bank's shareholders to whom the latter should channel their concerns where normal channels of communication have failed to resolve them or where they are deemed to be inappropriate under the circumstances.

As explained in the beginning of my address, corporate governance, although formally imposed upon banks in Cyprus only in the beginning of the current year, it was voluntarily taken on board by the four banks which are listed on the Cyprus Stock Exchange much earlier through the implementation of the Code of Corporate Governance issued by the Cyprus Stock Exchange. The basic difference, of course, between the requirements of the Central Bank's Directive and the provisions of the Code of Corporate Governance is that the former are mandatory and as such are subject to the Central Bank's supervisory review while the latter are voluntary and if not implemented disclosure is only required. Earlier this month the Council of the Cyprus Stock Exchange has published its revised Code of Corporate

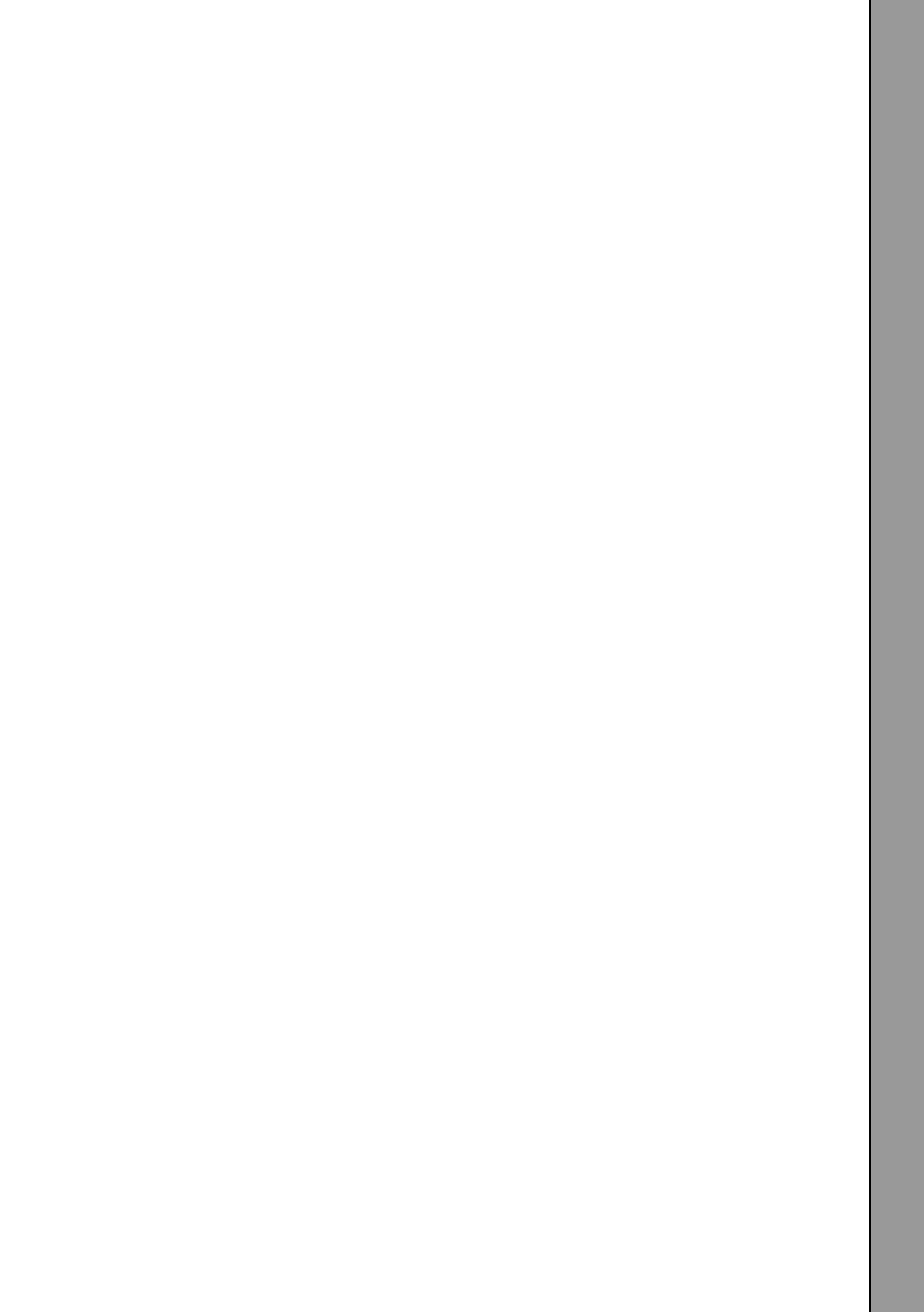
Governance which is going to be implemented at the end of next month. The voluntary basis of the revised Code has not changed as it effectively asks companies to "comply or explain".

The Central Bank's requirements, as outlined above, constitute a full panoply of measures which banks in Cyprus, without exception, must implement in order to introduce a robust corporate governance system or enhance their existing arrangements. The requirements which have been set are, I believe, quite high, by both European and international standards and since they have only become mandatory just three months ago and not yet been subject to an appropriate supervisory review by the Central Bank, it is quite early to assess their impact or effectiveness from a practical point of view.

Cyprus's financial sector has not experienced, I believe, any major corporate governance episodes of the likes of Enron or WorldCom and, in this regard, one could say that the requirements embodied in the Central Bank's Directive are of a preventive rather than of a corrective nature. Notwithstanding the above, Cyprus's accession to the European Union on 1st May 2004 and the consequent abolition of the power of the Central Bank to regulate entry into our banking industry on the basis of a rather general and open ended "economic" criterion, coupled with the liberalisation of foreign direct investment, has opened up Cyprus's banking sector to foreign investment as well as to mergers and acquisitions, some friendly and some hostile, activities which only a few years ago were almost unknown to both banks and their supervisors in Cyprus. It is, therefore, in this new context of market openness and globalisation that the corporate governance principles are acquiring even more importance for Cyprus's financial sector.

In conclusion, I should like to express once more, the Central Bank of Cyprus's honour and delight for organising jointly this seminar with SUERF. We are looking forward to hearing and learning more on the subject of corporate governance from the distinguished speakers and panellists whose contributions will follow today and tomorrow. Lastly, I should also like to wish all our overseas friends an enjoyable stay in our country and suggest to them that they either overstay for a couple of days or visit Cyprus again.

Thank you.



The governance of the banking firm

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Abstract

The paper reviews current theories of the firm and its governance to apply the insights to the banking firm. The theory of the firm now acknowledges that there is a role for stakeholders in governance even if that obfuscates the objective function of management. Additional stakeholders add to the firm's complexity, thereby making performance remuneration schemes more difficult to implement. The banking firm is a typical example of a firm in which depositors are stakeholders that deserve an allocation of property rights. I argue that such property rights are suitably enforced by a regulatory agency, and that a bank will thus always be a firm that serves two masters. It therefore should be more cautious defining performance remuneration schemes.

1. Introduction

For some fifteen years now, the research program of Ross Levine[1] together with a research group at the World Bank has lent econometric credence to an old presumption embedded for example in the work of Gerschenkorn (1962) that a functioning financial sector is a vital prerequisite for sound economic growth. At a macro level, research attention was directed to which kind of environments would be most conducive to a successful financial sector, and research demonstrated that the legal environment to enforce financial contracts assumed center stage[2]. There, promoting creditor rights to enforce debt contracts was equally important as defending minority shareholder rights for well-functioning stock markets[3].

At around the same time, the corporate finance literature started to generate an awareness that proper contract enforcement is a necessary but by no means sufficient condition for a successful market in financial claims: Shleifer and Vishny (1997) defined corporate governance as "the ways in which suppliers of finance assure themselves of getting a return on their investment". Obviously, the market for financial securities is fraught with ambiguities that often preclude the settlement of disputes in a court of law. Financial contracts are hence incomplete. The institutions of corporate governance then serve to fill the gaps left in such incomplete financial contracts[4].

As a consequence, a functioning legal environment could not be a sufficient condition to shape an efficient financial sector: the financial institutions themselves must not only operate in a conducive environment, but also need to be governed appropriately. Beginning with the observations by Prowse (1997a, 1997b), this led the literatures on corporate governance and financial regulation to merge for the case of banks[5].

The purpose of this paper is to build on this literature by taking on recent insights from the theories of agency and delegation, the firm, and its

[1] Levine and King (QJE 1993), Levine (JEL 1997), Levine (JFI 1999).

[2] Beck, Levine and Loayza (2000 JME).

[3] LaPorta, Lopez de Silanes, Shleifer and Vishny (JFE 2000), Demirgüc-Kunt and Levine (2001), Beck, Demirgüc-Kunt and Levine (JFE 2003).

[4] Klapper and Love (FM 2004) show that law and governance work as substitutes in emerging markets.

[5] Harm (2002).

governance, to be applied to banks and their management. The paper concludes that banks are institutions in which a limited stakeholder approach is more sensible than a pure shareholder approach. I take a more cautious stand towards shareholder oriented remuneration schemes in such institutions.

The paper progresses in two sections. Chapter two critically evaluates the state of corporate governance theory. It begins by rehashing the standard agency explanation for corporate governance structures, and outlines the shortcomings of the agency paradigm for a full understanding of governance institutions. It then moves on to generate insights for the governance of the firm by providing a state of the art assessment of the theory of the firm, and deriving implications for the financing of the firm. The resulting endogenous allocation of property rights then serves as a basis for a more general theory of corporate governance.

Armed with such insights, chapter three applies them to the governance of financial institutions, in particular banks. It is demonstrated that for banks, the stakeholder approach is more appropriate as a guiding principle than for most other firms, and that especially for bank managers, aggressive shareholder oriented remuneration schemes are to be judged inappropriate. Where feasible, the extant empirical literature is quoted to support the theses of this paper. Chapter four serves to summarize and conclude.

2. Corporate governance: popularity without theory?

Jean Tirole (2001) remarked that "for most economists and legal scholars, the debate is more on how to *implement* shareholder value than its legitimacy". Indeed, shareholder value derives its theoretical legitimacy from a short piece by Rappaport (1981) in the Harvard Business Review, which merely reflected the tenets of the agency paradigm which had assumed center stage in economic analysis in the 1980s[6]. Agency theory itself, however, merely posits the shareholders of the firms as owners endowed with full property rights. Whether the shareholders *should* be endowed with such property rights is not part of the analysis.

I will begin the analysis by demonstrating merits and shortcomings of agency theory before venturing on to modern insights on the theory of the firm, which will allow more profound conclusions on the nature of the firm, the allocation of property rights in the firm, the financing of the firm, and its governance.

2.1. The agency paradigm

The work by Arrow and Debreu (1954) had laid the foundations for economists to derive their insights largely in a setting of frictionless markets, and had thereby contributed to the success of the neoclassical paradigm. It was only the insights by Akerlof (1970) that led economists to question the general validity of equilibria involving rational utility maximizers interacting in frictionless markets where prices would always clear supply and demand.

If the information advantage of a seller of a good could lead to market failure, what about the concept of delegation so fundamental to a society based on the division of labour? Ross (1973) was the first to phrase the problem of an agent maximizing utility while being employed by a principal who could not observe the agent's effort. It did take another six years, however, for the problem to be 'solved': Holmström (1979) and Shavell (1979) simultaneously explained that the optimal agency contract would have to provide an incentive component over and above the optimal risk-sharing relationship between

[6] See Pratt and Zeckhauser (1985) for the standard volume on agency among economists, or Easterbrook and Fischel (1982) as a typical piece of work by legal scholars internalizing the agency dictum.

principal and agent. Vis-à-vis such optimal risk-sharing, the principal has to overcompensate in 'good states' and undercompensate in 'bad states' to elicit optimal effort on the side of the agent. Still, it was demonstrated that resource allocation deviated from the Arrow-Debreu 'first best', and that hence the information advantage of the agent would lead to inferior equilibria even in the best achievable setting.

The elegant solution provided by Holmström and Shavell laid the ground for the victorious crusade of the agency paradigm to explain various phenomena in many delegation situations, particularly when it came to the relationship between outside shareholders and managers in a corporation[7]. Rarely, however, was the allocation of property rights to shareholders ever questioned[8]: since shareholders were the *de facto* owners of the corporation, the application of the agency toolkit seemed straightforward. This was particularly so, since in the case of the shareholder manager relationship, the objective function of management was unambiguously to maximize shareholder value, and that for the publicly held listed corporation, this was measurable beyond doubt minute by minute at an eighth tick.

This latter point deserves particular mention since the Holmström/Shavell models impose an objective function on the agent to maximize 'X', which is what both principal and agent value. The original agency model does not allow disagreement in the measurement of 'X'. For the longest time, however, in a shareholder-manager application, this detail disturbed nobody.

Yet, there was a problem with the predictions of the Holmström/Shavell model: it did not talk about a specific agency relationship, but rather formulated a general theory of delegation. With that, it must have seemed surprising to some that in a society based on the division of labour, and hence delegation, by far the majority of work (and effort) is performed under contracts specifying flat pay schedules!

It is only as of late that disagreement about the agent's outcome of 'X' has entered the academic equation. Under the heading of 'subjective evaluation',

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[7] Actually, the first publication in Finance making reference to the agency problem by Jensen and Meckling (1976) derived its arguments without knowledge of the Holmström/Shavell solution by assuming that the market could react optimally to the agent's incentives for fringe compensation.

[8] Actually, Fama and Jensen (1983a, 1983b) argued that the owners of residual cash flow rights would have to own residual control rights because otherwise agency problems would become 'too large'.

researchers analyzed delegation situations such as a professor asking a doctoral student to ‘do good research’, or a restaurant guest asking the cook to ‘prepare something tasty’. Many examples can be cited that demonstrate the generality of agency relationships fraught by measurement problems.

The first closed-form solution to this problem was specified recently by McLeod (2003): by assuming conflict costs that decrease in the correlation of the measurement of the outcome by principal and agent, McLeod was able to show that conflict costs can dominate the intended incentive effect of the Holmström/Shavell model, and that if that happens, the optimal wage schedule for the agent is flat.

At least this author regards the findings by McLeod as one of the major milestones in understanding delegation situations, since it resolved a major empirical puzzle, namely that the vast majority of delegation contracts do not specify incentive components.

For our purpose at hand, the discussion of agency theory yields two major conclusions: first, agency theory does not talk about whether shareholders should or should not have property rights in the firm. It merely assumes this as the default allocation. Secondly, the more complex and fuzzy the objective function of management, the less likely that incentive components should be found in a compensation contract. We now continue to describe the firm and its management in order to get a closer grip on what needs to be ‘governed’.

2.2. The firm: protecting specific assets and providing strategic direction

For the longest time, the nature of the firm represented another challenge to the neoclassical orthodoxy[9]. In firms, workers accept directives by superiors, and thus didn’t allocate resources as freely deciding individuals in a market exchange. Why should contracts override the free will of enlightened homo oeconomicus?

One of the early answers was given by Alchian and Demsetz (1973): if the effort of workers is unobservable, the shirking externality makes the team want to sell itself to one owner, if that ‘owner’ has some monitoring capabilities of team member work input. The same result was later replicated

[9] Beginning with Coase (1937).

formally by Holmström (1982) in an agency setting. However, the managerial role reduced to 'monitoring' did not answer Coase's (1937) concern of fiat and authority.

Williamson's (1979, 1985) Transaction Cost Economics (TCE) provided a richer explanation: if contracting agents are boundedly rational, and if at least one contracting party has to invest in assets specific to the aspired business relationship, then the chance of post-contractual opportunism may render contracts incomplete such that no court of Law can reconcile contractual disputes. With that, the specific assets are expropriable, and the transaction would fail in a market environment. If, however, the two transacting parties would sell themselves to one owner, that owner would be financially indifferent in which of the parts of the firm the profits would accrue as long as the joint entity is profitable. The firm is then a means to protect specific investments against expropriation, while its management adjudicates intra-firm conflicts over the appropriation of the quasi-rents, which continue to exist, but where the two parties know that a compromise solution in the interest of all is found.

In this view of the world, management is a more successful mediator than the public court system is to market participants, but it is still not providing strategic guidance as Coase (1937) may have envisioned it when he said that "a worker does not switch from department A to department B because of a shift in relative prices, but because he is ordered to do so".

I have given my own explanation of how to explain a role for management that includes strategy formulation and implementation[10]: in a world of subjective beliefs, individuals are likely to disagree on a proper course of action. With disagreement and communication to arrive at an enlightened solution to a group decision-making problem being costly, this decision mechanism favours the status quo. If the firm (or the team, or any other entity to be managed) finds itself in a dynamic downward spiralling equilibrium, only decision-making by fiat can escape this equilibrium. While I cannot provide an explanation *which* decision path will prevail, I *can* argue that the bias of the group decision-making process for the status quo motivates a central planning function of management not elsewhere discussed in the economic literature. The core of the economic argument lies on communication costs in the presence of subjective beliefs and costly learning.

[10] Harm (2002, pp. 10-14).

This latter view of management has far reaching implications for the nature of the management position. Creating a position of authority for strategic direction does not solve the problem of dissent in the group. Hence, authority needs power to override dissent, and conversely, authority without dissent is unnecessary. Yet, once we endow an authority with power, it may start to use that power opportunistically, e.g. for rent-seeking purposes. Any dissent against such behaviour can also be quieted by the power the office is endowed with.

It is presumably this paradox that led Kenneth Arrow (1974) to conclude his essay on “The Limits of Organization” by claiming that organizations need ‘infrequent revolutions’ to change management. I called this the *paradox of authority*: management needs power to override dissent, but ‘too much’ dissent necessitates management replacement.

This *paradox of authority* exposes a corporate governance problem: if we follow the interview evidence by Demb and Neubauer (1992) that boards in many countries perceive their most important role to be selection and dismissal of management, the *paradox of authority* explains that there can be no room for the concept of optimality in this role.

A second problem of supervising management by a board of directors is that the role of providing strategic guidance may not be compromised by the board: an overly activist board in matters of strategic guidance (i.e., a board which frequently overrides management proposals) becomes management itself, and needs to be supervised as such. The ensuing corporate governance cascade has many features of an infinite regress[11]. The only solution can be what I called a *long leash* or *enlightened self-restraint*.

We end this section by postulating three different views of the firm and its management: the manager as monitor to overcome shirking externalities, the manager as judge to protect specific investments, and the manager as provider of strategic direction.

2.3. Financing the firm: the allocation of property rights

The section on agency could conclude that agency theory itself does not derive the allocation of property rights for shareholders. In my SUERF

[11] Or, as Douglas Adams had put it in his famous ‘Hitchhiker’s Guide to the Galaxy’: “Who controls those who control the people who are in control?”

study[12], I advanced an argument for how financial securities are awarded different property rights based on TCE reasoning[13].

The argument was that ALL of the equity investor's investment is a specific asset, since equity is paid last. Because of that, the equity investor is financially interested in every marginal managerial decision. Yet, bounded rationality precludes writing a contract over the strategy space, while the above mentioned *paradox of governance* precludes in-depth boardroom disputes on strategy and firm policy. A reputational equilibrium is presumably too instable in financial markets[14]. This leaves the hierarchical solution as the only one to protect the equity investor's specific investment. I argued in Harm (2002, p. 15–16) that the equity contract would then include provisions to liquidate the business, and possibly to replace the manager. This, however, amounts to a definition of property rights. The contractual previsions lower the specificity of the equity investment from the full amount to the lower of the losses in liquidation or the losses in management transition.

Debt claims are different since they promise a fixed amount[15] and enjoy seniority over equity. This makes the investor no longer interested in every marginal managerial decision, which dramatically reduces the necessary contracting space between investor and entrepreneur, and the contractual solution becomes feasible. It is only when the fixed return is threatened that the incentive schedule of the equity investor and the debt investor begin to overlap, and the creditor will also demand property rights. Hence, debt demands *contingent* property rights.

I argued that the more boundedly rational investor will prefer debt over equity investments since monitoring the equity investment, i.e. filling the corporate governance role embedded in the property rights of equity, is deemed too costly. Since the likelihood of non-performance decreases in the interest rate charged, a lower interest places lower demands on creditor monitoring, at least in expectation. In that sense, I regard debt as a satisficing claim in the sense of Herbert Simon (1978). At the level of the financial intermediary, the simplicity of managing debt contracts allows the loan officer in a bank to

[12] Harm (2002).

[13] To be sure, Williamson (1988) already provided a TCE analysis of financial securities. However, he only argued *that* financial securities could be awarded different control characteristics, but did not derive *how* to award them based on their cash flow properties.

[14] As the experience with sovereign debt has shown even in the case of infinitely lived borrowers.

[15] Which needs to be less than the expected return on equity.

manage many more accounts than the manager of equity participations in a venture capital firm.

Tirole (2001, p.19) opined that "explaining the existence of multiple securities with differentiated control rights is one of the main challenges currently facing corporate finance theory", and delivered four avenues of explanation: a) differential investor demands, b) liquidity, c) monitoring, and d) control rights, where multiple securities can jointly act as a disciplining device. Our explanation based on Transactions Cost Economics reasoning encompasses elements of a) and c).

Moreover, however, the reasoning endogenously explains the allocation of property rights among two classes of stakeholders: creditors and outside equity investors. The analysis of the specificity of the investment is crucial for the allocation of property rights, and hence governance rights.

2.4. Shareholders, stakeholders, and property rights in the firm

We can now move to a more detailed assessment of Tirole's (2001) discussion of the stakeholder philosophy. Any party with significantly specific assets committed to the firm will demand property rights. Think about TCE in its pure form as a theory of vertical integration. Depending on the nature of the integration, one can re-interpret it as a supplier[16] or a customer[17] trying to protect specific investments by integrating them into the other firm, becoming partner, and thereby receiving property and governance rights.

One could think about highly specific human capital which a worker may need to acquire, even though empirically the case is likely to be overrated, specifically in the case of German Codetermination. Nonetheless, the view in which the firm protects the specific investments of a variety of stakeholders seems feasible.

The discussion by Tirole (2001), however, explains why not all stakeholders can receive equal property and governance rights. The resulting cacophony of mandates for management leaves its objective function confused at best, which obscures the measurement of its achievements, which in turn defeats all efforts to demand accountability. The experience of the Socialist Firm comes to mind.

[16] E.g. the infamous Fisher Auto Body and General Motors Case.
[17] E.g. forward integration of natural gas producers into wholesale distribution.

The poor performance of many public sector owned firms may be another indication for the validity of Tirole's claims: with every additional stakeholder sharing property and governance rights, the firm may be forced to internalize externalities, but the accountability of management becomes obfuscated. The graver rent-seeking efforts of management on behalf of shareholders (or existing stakeholders) are curtailed, but at the expense of organizational efficiency.

Nonetheless, the view of stakeholders receiving property and governance rights when their investments in the firm are highly specific has put shareholder value into perspective.

As a corollary, we can now combine the insights on the stakeholder view with McLeod's (2003) analysis of agency relationships where managerial output is difficult to observe: the more different stakeholders need to share the property rights in the firm in order to commit their specific investments to the firm, the more obfuscated the managerial mandate, and the more difficult to measure managerial output appropriately. Clearly, then, the arrival of each additional stakeholder at the gates of the firm reduces the appropriateness of incentive schemes in managerial remuneration, especially stock options reflecting shareholder value.

Currently, a more refined view of the firm, its management, and its governance is emerging from US scholars of Corporate Law. Hansmann, Kraakmann and Squire (2006) observed that much of Corporate Law seems to be devoted to shield the corporate entity from outside claims, including from the owners of the firm. To shield the corporation from its owners is rather the opposite of the concept of shareholder value. Yet, the bankruptcy of a shareholder could potentially threaten the firm itself.

The question is: why is the firm itself worthy of protection? Why couldn't the market redeploy the assets and move on? One view would see the firm as an accumulator of rents which all stakeholders try to lay their hands on. Obviously, competition should impose solid limits on such rent accumulation. A more plausible explanation – and one that is consistent with the theory of the firm itself – has been advanced by Blair and Stout (2006): that the firm is a collection of specific investments of various stakeholders, and that the commitment of an asset into the illiquidity of the use within the firm creates quasi-rents that need to be protected.

Hence, Blair and Stout (2006) claim that this kind of reasoning opens the door to understanding the stakeholder economy, and the reason why shareholder

value, which has been much discussed in the context of agency theory, has never materialized significantly into corporate law. To the contrary, the doctrine of entity shielding places the role of guardian onto the management of the firm, to protect it from attempts of outside rent-seeking, including from shareholders.

Obviously, such view of the firm opens it up to all ambiguities of the stakeholder controlled firm as mentioned by Tirole (2001)[18]. The objective function of the firm becomes obfuscated, the accountability of management becomes fuzzy, and the task of corporate governance becomes clouded. Nonetheless, this is because of legitimate interests of stakeholders having committed specific assets to the corporate purpose, and it may then be a superior arrangement to shareholder value, if the investors in specific assets have no reasonable prospect of securing their claims by contractual means.

This, however, remains a powerful caveat to the stakeholder doctrine: that a focused firm guided by shareholder value, where management is constrained by contracts imposed by the various stakeholders, may work more effectively than a firm guided by stakeholder cacophony. It is quite plausible that those stakeholders, who commit intangible financial resources junior to all other claims, have committed the most specific asset in the firm. Hence, it comes at no real surprise that the default allocation of property and governance rights belongs to shareholders. Important is the insight that other stakeholders can and do make the case that property rights in the firm need to be awarded in a more complex way.

It is in this mode that I now turn to the governance of banks.

[18] Or the critique by Jensen (2001) on the stakeholder view and the balanced scorecard.

3. The governance of banks

It is no news that banks are 'special'. The combination of demandable debt contracts, illiquid investments and high leverage has interested researchers too numerous to do justice to at this point. Because of the said properties, banks are at all times illiquid but solvent, and mere rumours of possible financial weakness could spark an (irrational) bank run sending the institution to insolvency. To counter the (societally wasteful) distress sale of illiquid bank loans, it is rational to provide deposit insurance (usually run by the government) but in return monitoring and regulating financial institutions for the resulting moral hazard problem.

In Harm (2002, pp.30–36), I motivated such bank regulation and supervision as debt governance: depositors incapable of managing the supervision of their claims hire regulators through the public choice mechanism to do it for them. I am here going to build on that representation by adding the conceptual lens of entity shielding and the stakeholder controlled firm.

3.1. Banks and entity shielding

If ever there was a case to be made for the view of the firm as a collection of illiquid assets, banks would certainly fit that view almost stereotypically. Inasmuch as loans form a large part of the left-hand side of a bank balance sheet, banks *are* a collection of illiquid assets. This is not withstanding the various intelligent schemes now in operation to securitize bank loans. Common to all such schemes is that the originator keeps the last risk segment, so that the point of loan securitization is geared towards liquidity and possibly market imperfections in the pricing of top rated securities. The risk structure and with it the corporate governance problem of depositors remains largely unaffected.

Also of interest are the positive externalities emanating from banking institutions. Presumably, various segments of society benefit from a stable and efficient banking sector through the provision of transactions accounts and the payments system, the provision of finance for long-term investments and working capital, the advisory role for private and corporate clients alike. Even though I am not aware of an attempt at measuring this, I would regard the value to society over and above the cost of the banking sector as immense.

One need only think of the work of Ross Levine cited in the first paragraph of this paper, which provides a direct link from a functioning financial sector to economic growth at large.

I would view such value added to society as society's specific asset in the banking sector: its existence is a quasi-rent, and it is vulnerable to expropriation by opportunistic managerial action[19]. Since bank runs can be contagious, the misfortune of a single bank can theoretically threaten society's value added from a functioning banking system. Along the lines argued above, this would make society – or politics – a natural stakeholder in each individual bank and the entire banking system[20].

Probably more contestable is the view of a loan officer whose detailed knowledge of his clients would be worthless in a new employment setting. First of all, most firms have more than one bank relationship so that the loan officer could apply his knowledge with a new bank employer. Even if a competing bank had no business relationships with the firms the loan officer has detailed knowledge about, it would probably value the knowledge highly. As with much of the debate on human capital, the default is that an employee takes his or her human capital to the next employment. Hence, human capital does usually not qualify as a stakeholder in a firm[21].

Customers and suppliers are identical to borrowers and depositors that were already covered in the discussion above, and need not be talked about again. Another question is whether suppliers of critical services should be mentioned, such as the whole information technology complex, which banks use extensively. At a time, when many firms contract out their IT services, it seems unlikely that highly specific investments are associated with this function.

This brief run-down of important stakeholders has left the depositors and the public at large as potential candidates for an allocation of property rights over and above shareholders. Obviously, if the depositors cede their governance

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[19] It could also be individually rational for bank shareholders to liquidate their bank, but this could then impose grave externalities on all other members of society.

[20] Note, however, that the value added of banking services above cost must be very large indeed, else one could make this type of argument for regulation for many industries where competition erodes surplus.

[21] German unions would typically mention the high long-term unemployment in Germany as evidence for a substantial quasi-rent - the same argument Tirole (2001) mentioned for France. Whether Codetermination is the correct answer over and above more flexible labour markets remains a matter of debate.

rights to public regulators, the two stakeholders merge into one: a public regulator interested in financial stability at the institutional as well as societal level. With equity and debt not exactly sharing property rights, but rather defining a hierarchy where equity's property rights assume the default case, while debt steps in during times of distress, the typical problem of the stakeholder corporation as a convoluted structure with ambiguous guidance to managers is lessened. Nonetheless, the analysis by Prowse (1997a, 1997b) demonstrates that even in regular times, bank regulators enforce their governance mandate parallel to that of shareholders. Hence, the banking firm has a more complex mandate than other firms.

3.2. The mandate of bank managers

Of course, this analysis of the banking firm is not exactly new: I just meant to provide a new context with recent developments in the theory of the firm. In the past, John, Saunders and Senbet (2000) had argued for the bank managers to receive incentive remuneration also based on depositor interests. Macey and O'Hara (2001) called for expanding the fiduciary duty of bank directors to depositors. Reasons for such arguments lie in the large externalities equity could potentially capture from depositors in highly leveraged banking firms.

Hence, Noe, Rebello and Wall (1996) and Osano (2002) come out against equity-based incentive remuneration for bank managers, while Ang, Lauterbach and Schreiber (2000) reason that bank regulators should cap equity incentives for bank managers. Ciancanelli and Reyes-Gonzales (2000) go as far as to argue that significant equity investors in banks can have a destabilizing influence. In keeping with the above analysis, also this paper would argue strongly that bank managers' attention needs to be first directed to the banking firm as a whole, and should only as a secondary interest devote attention to shareholders in particular.

3.3. Some empirical evidence

In the following, I want to survey empirical evidence from three different areas which allow an assessment of the nature of equity and equity-like incentives for managers of banks. This section is largely based on my previous analysis in Harm (2002, Ch. 2).

The first area is the evidence on the success of cooperative banks. In a cooperative bank, typically every shareholder is depositor (and possibly borrower) at the same time, and therefore has a more holistic interest in the institution. Already Rasmussen (1988) claimed that mutual managers would be more risk-averse than their corporate peers, and that this would appeal to regulators and depositors alike. Yet, this apparently does not compromise performance: mutuals did not underperform savings banks in the US[22], the UK[23], Germany[24], and Italy[25]. At the same time, evidence from the US suggests that credit unions did not engage in aggressive risk-taking as did their S&L counterparts[26], and that therefore a similar crisis as in the case of the S&L's never materialized[27]. The union of shareholder and depositor is arguably the reason for the success of cooperative banks, which may be the reason for why the cooperative form is prevalent in the banking sector of many countries, while it has become virtually extinct in most other industries.

The second area of empirical evidence concerns the role of management ownership stakes in banks. Here, the empirical literature has identified similar mechanisms as the literature on management ownership in general[28]: that low levels of ownership provide incentives, and that incentives yield performance, but that at high levels of ownership performance incentives are overshadowed by entrenchment[29]. Yet, in terms of risk-taking, the evidence is mixed: while Saunders, Strock and Travlos (1990) or Chen, Steiner and Whyte (1998) demonstrate that institution risk is lower with higher management ownership, the evidence from the S&L crisis suggests that prior to applying more regulatory stringency through FIRREA, management ownership was associated with risk-taking[30]. It seems that the link between the studies with such opposing results is bank charter value: in low charter value banks, managers with equity incentives may value the option feature of equity and

[22] Mester (1993), but contradictory evidence was found by Cole and Mehran (1997).

[23] Valnek (1999) found that mutual building societies outperformed comparable stock retail banks. Holmes and Llewellyn (1997) showed that mutuals suffered no shortcomings from not being able to be disciplined by the takeover market.

[24] Altunbas, Evans and Molineux (2001) or Kregel (1997).

[25] Ferri, Masciandaro, and Messori (2001).

[26] Esty (1997a, 1997b) and Karels and McClatchey (1999).

[27] Kane and Hendershott (1996).

[28] Morck, Shleifer and Vishny (1988).

[29] Allen and Cebenoyan (1991) and Hadlock, Houston and Ryngaert (1999) analyze evidence from takeovers, while Carter and Stover (1991), Boyle, Carter and Stover (1998) and Aharony Falck and Lin (1996) observe managerial behaviour in mutual to stock conversions of thrifts.

[30] Cebenoyan, Cooperman and Register (1995), and Knopf and Teall (1996).

shift asset risk to a higher level. Higher charter value, in turn, restores prudence[31].

This insight is again mirrored by the evidence from the third area of empirical research to be sampled here, namely the work on management remuneration: evidence by Crawford, Ezell and Miles (1995) or Evans, Noe and Thornton (1997) points in the direction of equity-like incentives exploiting the debt (FDIC) externality, while Houston and James (1995) link equity-like incentives to charter value, interpreting this as inconsistent with risk-taking.

3.4. Competition, charter value, and managerial incentives

With the positive features of charter value for shareholders and depositors alike, it would be easy to conclude that the deregulation that had swept the financial industry over the last thirty or more years in many countries was misguided. However, this is precisely what Berger and Hannan (1998) speak out against: the move to more competition may reduce charter value in the short-run[32], but the X-inefficiencies associated with less competition quickly consume the benefits of bank charter value.

Recent research by Beck, Demirgüc-Kunt and Levine (2006) has shown that while concentrated banking markets are less likely to experience financial crises, moves from policy makers to achieve concentration by hindering competition yield the opposite result. To the contrary, Claessens (2006, p. 14) argues that opening financial sectors to competition has ‘generally led to greater product differentiation, lower cost of financial intermediation, more access to financial services, and enhanced stability’.

It seems in order to determine the exact relation between competition, concentration, charter value, and safety in banking before deciding on the mandate of the management of financial institutions, and devising a proper governance environment.

I have argued elsewhere[33] that the astounding concentration observed in the world markets for corporate bonds and syndicate loans can be explained by

[31] Demsetz, Saidenberg and Strahan (1997), Cebenoyan, Cooperman and Register (1999), or Anderson and Fraser (2000).

[32] Keeley (1990).

[33] Harm (2001).

the reputational equilibrium[34] between issuer and intermediary as well as between intermediary and ultimate investor that develops in response to the asymmetric information problem. Once a bond underwriter has established a reputation with an institutional investor, or a firm has established a reputation with a bank acting as syndicate leader in the loan market, these relationships act as a natural barrier to competition. I am inclined to treat the nature of the financial product as the main explanation to concentration in the industry despite vivid attempts by all players to compete with each other.

Then, a liberalized financial sector will experience competition for individual transactions, while one can at the same time find loyalty bonds between customers and intermediaries unimpressed by such competition. Such loyalty bonds I would view as cornerstone of a concentrated market structure capable of delivering charter value in the face of full competition. Of course, there needs to be a sizeable market segment where competitive attacks are rewarded with success in order for the fruits of competition to be reaped, but as long as a large segment of the market thwarts competition through loyalty, charter value is systemically preserved.

The result would thus be a concentrated financial market inhabited by X-efficient financial institutions, but in which charter value insulated institutions against systemic shocks.

Thus, financial institutions clearly benefit from management proactively defining their position in their market environment, which speaks in favour of management incentives. What is not so easy to determine is how to define the said incentives properly without compromising regulatory interest.

This paper has no clear answer to this question except to argue for complex remuneration contracts that are capable of distinguishing the source of success: charter value vs. the option value of equity, or productive vs. destructive risk-taking. If this is feasible, incentives can be structured such as to reward particular strategic achievements such as the market share, acquisitions, or cost efficiencies. Naturally, the stock price will – for listed banks – reflect both desirable and undesirable sources of bank shareholder value. Hence, the instrument of stock options should be used more cautiously for banks than for other firms.

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[34] Akin Kreps and Wilson (1982).

A brief (and incomplete) survey of actual banking practice seems in order. In Germany, Eickhoff (2001) and von Hoeren (2003a, 2003b) document the widespread use of variable compensation practices in German banks. However, much of that used to be camouflaging a fixed raise without effect for the employer's pension plan, or other non-variable schemes. Also, the surveys covered not only top managements, but also second and third tier middle managers. What could be documented is a widespread use of idiosyncratic remuneration agreements based on specific goal achievements. Notably, von Hoeren (2005) documented a lower share of variable compensation in cooperative banks.

The use of share price based compensation has been examined by Filbert and Kramarsch (2005). Unlike their international competitors, the four German banks with listed shares had stock option programs only for the top management tier, but there extensively. Also among the largest 30 international banks, the authors found extensive use of stock option programs. However, this does not answer the quantitative extent vis-à-vis industrial firms. This has been analyzed by John and Qian (2003), who verified that banks had a lower pay-performance sensitivity than industrial firms, and that also higher leveraged industrial firms display lower pay-performance sensitivities, presumably for the same reasons[35]. However, whether an average of $4.7 executive pay per $1000 profit in banks is significantly different from the $6 found in industrial firms in an economic sense remains a matter of debate.

My conclusions at this point are that banks *can* issue executive stock options, but should confine them to a secondary place behind other long-term incentives based on success criteria that further shareholder interest without compromising the regulatory mission. Option awards deemed too aggressive should be viewed as a red flag on the side of regulators. Managerial incentive schemes should first of all reward success in terms of the entire balance sheet, before singling out the particular concerns of shareholders.

This, however, makes incentives for bank managers more complex, less well-defined, and therefore the problems discussed by McLeod (2003) could surface: incentive programs that provoke disagreement invite conflict. Banks must rely less on pecuniary incentives than other firms, which is a consequence of their stakeholder character to internalize externalities.

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[35] This result is corroborated by von Hoeren (2005) for Germany.

3.5. Task complexity, and the 'how' of governance

If the mission of bank managers is more complex to define, a natural consequence will be that – in the sense of McLeod (2003) – bank manager's evaluation will be more subjective than that of managers in other firms. This will directly imply a 'healthy dose' of McCarthyism in the governance of the banking firm. This would be true both for equity governance principles from the side of shareholders, as well as debt governance principles from regulators.

I had mentioned in the beginning that the nature of management, which implies the paradoxes of authority and its governance, defies the definition of optimality criteria in governance policy. This natural ambiguity is further exacerbated by the stakeholder character of the banking firm.

The vagueness inherent in regulatory governance shows in the following quotes from Hüpkes, Quintyn and Taylor (2005, p. 17): "in some circumstances, the RSAs might decide to forego formal enforcement action in favour of cooperative compliance, while uncooperative, intentional violators may be dealt with strictly". "In cases of criminal misconduct, RSAs generally have the obligation to pass the case to the criminal authorities for prosecution. Oftentimes, however, the facts will be less clear so that there remains some scope for determining the most appropriate enforcement action."

Complexity implies contractual incompleteness, which implies subjectivity.

Rather than treating this as a structural defect, my claim is that the nature of governance makes situations as these the best achievable equilibrium. Hüpkes et al. (2005, p.27) go on to show that regulatory discretion is rather difficult to challenge: "Courts, in practice, exercise restraint and defer to the expert knowledge of the supervisors, given that they do not normally possess the expertise in financial matters. Substantive accountability is, therefore, of less significance, and judicial review is generally limited to review of legality with a view to ensuring that discretion is not exercised in bad faith or for improper purposes. Judicial review needs to be limited and time-bound in order to avoid that the process will stand in the way of regulatory and supervisory efficiency and effectiveness".

Compare this to a statement from a board member interviewed by Demb and Neubauer (1992): "We do not know what directors are supposed to do; we only know that they are supposed to do it 'with care'."

Equity and debt governance are fraught with ambiguities, especially in the banking firm. My claim is that pecuniary incentives risk the distortion of the managerial mandate away from the hazily defined objective function of the banking firm, and towards a 'rule-based' attitude in the sense that Llewellyn (2000) quoted Simpson: "In a market which is heavily regulated for internal standards of integrity, the incentives to fair dealings diminish. Within the company culture, such norms to fair dealings as 'the way we do things around here' would eventually be replaced by 'it's OK if we can get away with it'".

As Frey and Jegen (2001) have shown, explicit reward mechanisms have the capacity to crowd out intrinsic motivation, which can work better in complex environments. Due to its particular nature, the banking firm is more complex than most other firms. An approach, where the governance institutions of the banking firm select a properly motivated[36] top management into place seems superior to defining pecuniary reward mechanisms that intend to provide the proper motivation where none existed before. For this reason, it is advisable that also regulators have at least some say on top management selection and possibly remuneration packages.

[36] Note that this line of arguments steps out of the realm of economic analysis, as 'culture' and 'values' are strictly exogenous to the economist.

4. Conclusions

This essay has briefly discussed salient issues of corporate governance in general, and the governance of the banking firm in general. First of all, we showed that the peculiarities of the management function of providing strategic guidance imply paradoxes that cloud the governance function in ambiguities. Secondly, it was shown that the classical paradigm of analyzing corporate governance – agency theory – has just been enriched by the study of incomplete agency contracts to render the conclusion that the more poorly the objective function of the agent is defined, the less likely it is that a performance schedule will achieve the desired results. Complexity works against incentives. Thirdly, the current economic debate on corporate governance was shown to open at least a small avenue in favour of the stakeholder philosophy, when some stakeholders place similarly specific assets with the firm as shareholders. Nonetheless, the result is a firm with a more complex objective function. Finally, the modern theory of the firm is currently enriched by scholars of corporate law, who argue that corporate law shields the entity called firm from rent-seeking attempts by all sorts of stakeholders – including shareholders, because of the specific investments the said stakeholders committed to the firm.

Armed with this toolkit, the paper has then moved on to discuss the governance of the banking firm. Because of its high leverage and illiquid assets, the depositors of the banking firm have governance interests of their own rights, which they delegate to regulators through the public choice mechanism. Secondly, also the consumer surplus enjoyed by the public at large can be interpreted as a quasi-rent, nonetheless with governance implications rather indistinguishable to those of depositors and regulators.

The result is a firm that serves at least two masters: shareholders and regulators. Thus, the banking firm is defined by a more complex objective function than most other firms, and the stakeholder view matches the situation of the banking firm at least somewhat. Therefore, the objectives of management are harder to define, which clouds the definition and general applicability of performance remuneration in banks.

The detailed discussion of performance incentives for bank managers revealed that the interests of shareholders and depositors are congruent in the case of charter value, but divergent when it comes to the option character of

equity. An intelligent performance remuneration scheme could principally use bank stock options, if combined with other long-term incentives geared towards charter instead of option value. These, however, tend to be more complex so that the general ambiguities associated with the concept of governance could imply that in the banking firm, selecting managers with a proper intrinsic motivation may be superior to defining complex remuneration programs.

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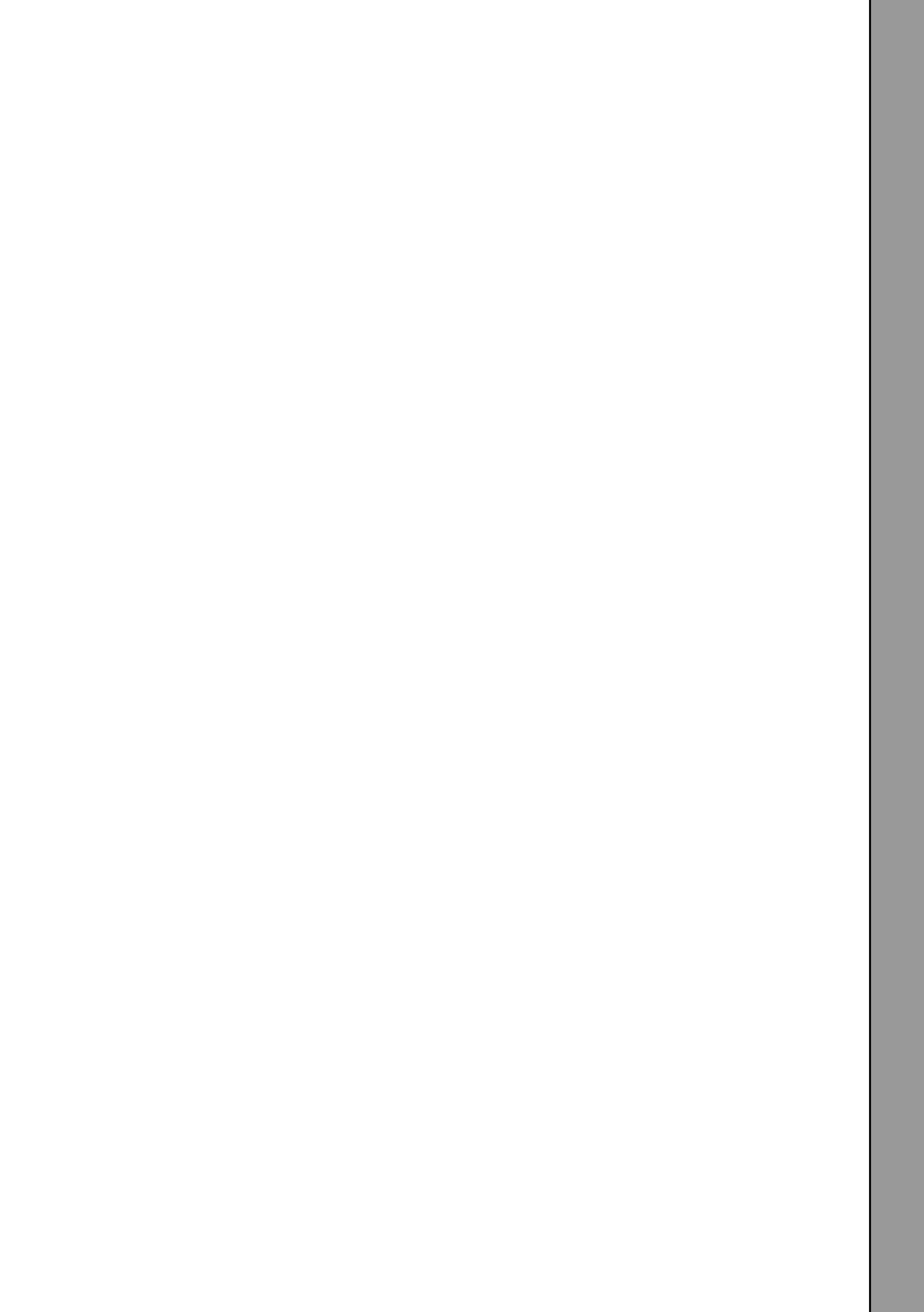

Corporate Governance Issues in *Non-Shareholder Value* Institutions: a Case Study of Mutual Building Societies in the UK[1]

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1. Introduction

Unlike most other industries, financial systems in Europe are populated by a variety of different types of banks with a varying mix of Public, State, Co-operative, mutual, and private or incorporated banks. There is no homogeneity and this extends, for instance, to how different classes of banks define their ultimate business objectives. In this last respect a distinction has been made between *Shareholder Value* (SHV) and *Stakeholder Value* (STV) banks (Llewellyn, 2005, 2006).

There is no universal view in Europe about the role and ultimate objectives of companies and in particular whether, as in some Continental countries, the company is viewed somewhat as a social institution that exists for the benefit of many types of stakeholders, or whether (as in the stereotype Anglo-Saxon model) it is essentially a financial entity with primacy given to the shareholders/owners of the company who are the ultimate suppliers of risk capital. This distinction encompasses different views about who are the relevant stakeholders, the relative role of shareholders in the overall stakeholder mix, the clarity of the bottom-line objectives of companies, and the exclusivity of the profitability objectives of companies. It also has implications for the role of capital market discipline on companies and the market in corporate control which tend to be more powerful in SHV than in STV regimes.

The distinction between STV and SHV models is ultimately about the bottom-line business objectives of banks. While the distinctions are in practice complex, the SHV model is based on the notion that banks (in fact, all firms) exist primarily to maximise shareholder value and hence the rate of return on equity. Shareholders are the owners of the bank and the ultimate risk-takers. We shall refer to these banks (or companies) as "incorporated". In contrast, in the STV model there are many stakeholders in a company of which shareholders are only one. In the STV approach, while profitability is one of the objectives of the bank, it is not necessarily the exclusive, or even primary, objective. It is more an issue of balancing the different interests of the various stakeholders in the company. In practice, this means that an STV bank will not pursue profit maximisation to the same degree, or with the same intensity, as will SHV banks, (Llewellyn, 2005).

The nature of the distinction is illustrated by a recent comment made to the *Financial Times* by Ferdinand Piëch (Chairman of the Supervisory Board of VW and a member of the family that controls the Porsche Company):

> "Yes, of course, we have heard of shareholder value. But that does not change the fact that we put customers first, then workers, business partners, suppliers and dealers and then shareholders"

For purposes of this paper, STV banks are banks (or other financial institutions such as life assurance firms) which are not incorporated (e.g. mutuals, Co-operatives, etc) and crucially who do not have tradable ownership stakes. Particular examples of the first type include Landesbanken and Savings Banks in Germany which are not owned by shareholders whose equity holdings can be bought and sold in the secondary market. As noted below, the tradability of ownership stakes is a key difference between SHV and STV banks, and raises important issues in corporate governance. In some cases, the same could apply to state-owned banks. However, some State banks are incorporated and board members appointed by the state may be focussed on shareholder value on behalf of the state.

The focus of this paper is on corporate governance in non-incorporated financial firms. The paper is designed to highlight the governance issues in mutuals in the context of what will be termed an *Agency Paradigm*. A central issue to consider is whether governance arrangements are common for all firms or whether the special characteristics of some firms (e.g. because they are mutual) mean that optimal governance arrangements will vary between different types of firms. In this last respect, the argument will be that optimal government arrangements are likely to differ as between different types of companies because ownership structures vary between different types of firms, their objectives might be different, the nature of risk-sharing will vary in different corporate structures, and there will be differences in the incentives, ability and feasibility for stakeholders to conduct monitoring and exercise control over the management of firms.

Issues of corporate governance have become a focus of attention in many countries and several have recently established enquiries into its operation. This has been partially generated by a series of spectacular failures in governance arrangements. However, there has also developed a more general concern that corporate governance arrangements have not been operating as they should. In the UK, in particular, corporate governance is a subject that has been the focus of considerable discussion and analysis for over ten years

and several official reports have been produced: the Cadbury Report (1992), followed by reports by Greenbury (1998), Turnbull (2001), Smith (2003), Hampel (1998), and Higgs (2003). These have been codified in a Code on Corporate Governance known as *The Combined Code*, (Financial Reporting Council, 2003) which outlines a set of generally accepted principles of best practice for corporate governance in companies.

The focus of these reports has been on governance arrangements in incorporated companies generally and, perhaps surprisingly (though the BIS is a notable exception, BIS, 2003) comparatively little attention has been given to the special circumstances of financial firms in general and non-incorporated firms in particular. In the UK, for instance, the focus of the *Combined Code* is on publicly quoted (SHV) companies and does not address the specific governance issues of non-SHV companies

The purpose of the current paper is to set out an overview and survey of the corporate governance issues related to mutual financial institutions and, in particular, with respect to mutual building societies and life assurance institutions in the UK. This will be compared with governance issues in the case of incorporated or private banks (Public Limited Companies in the UK context). There is no explicit discussion of the merits and drawbacks of mutuality *per se* which are considered elsewhere (e.g. Drake and Llewellyn, 1997 and 2003). Although the specific focus will be on British building societies as a case study, and we recognise that the nature of STV banks varies between countries, the analysis may also be pertinent to Europe's other non-incorporated (STV) institutions more generally. However, optimal governance arrangements will vary according to the precise nature and ownership structure of the STV banks in question and these vary between countries.

In the UK, building societies are tantamount to being mutual banks (although technically they are not defined as banks) which conduct retail savings and mortgage business plus a limited range of other retail financial services. By definition they are mutual which means they are owned by their Members who are depositors and mortgage borrowers. Members have certain ownership rights including voting at Annual General Meetings where (unlike with incorporated banks, where voting rights are proportional to ownership stakes) each Member has a single vote irrespective of the size of deposit or loan. In other words, voting rights are not proportional to the size of ownership stakes. One of the Members' other powers is to vote for conversion to bank (SHV) status and several of the largest building societies have made

such conversions. A further key point with respect to governance, and again in contrast to incorporated banks, is that there is no separation between customer and owner as ownership rights accrue by becoming a "customer" (Member). Ownership rights cannot be traded as there is no externally-held share capital which also means that mutuals cannot be purchased in the open market by other financial institutions or companies although Members can vote for a transfer of engagements. The central point is that there can be no hostile bid, and hence there is no active market in corporate control.

2. Corporate governance

With respect to incorporated companies, corporate governance has been defined in two similar ways:

> "the mechanism by which corporate actions, assets, and agents are directed at achieving corporate objectives established by the corporation's shareholders... [Corporate governance arrangements] are the means by which corporate agents are held accountable to the shareholders for achieving the corporation's objectives." (Sternberg, 2004).
>
> "institutional arrangements which are designed to control relationships between the various stakeholders in firms, and which affect the actions of different stakeholders". (Gelauff and den Broeder, 1997).

More comprehensively, in its Principles of corporate governance, the OECD offers the following definition:

> "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure though which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined", (OECD, 2004).

It is this traditional concept of governance that is the focus of this paper rather than the much broader concept of internal management issues that is sometimes encompassed in the term "governance".

Given that all firms (mutuals or incorporated) utilise economic resources in their activity, issues of corporate governance are economically important for three central reasons. Firstly, there is the issue of what objectives firms pursue and, amongst the various stakeholders in a firm, in whose interests firms are run. Secondly, monitoring and control, and the market for corporate control, have an impact on the allocation of resources in the economy, and which firms end up managing economic resources. Thirdly, they impact on the efficiency in the use of resources within firms (Sinha, 1996). The issues are ultimately about resource *allocation* and resource *efficiency*. For these

reasons, inefficiencies in either corporate governance or the market for control of firms have significant costs for the economy. As put by Kim and Nofsinger (2007): “effective corporate governance can instil confidence, and hence trust, in our companies and markets”.

With respect to mutuals, the Myners enquiry argued that a mutual is no different from any other type of enterprise in needing good governance, and that “the fundamental purpose of corporate governance is clearly as relevant in mutuals as it is in proprietary companies”. However, most analysis of governance has been focussed on incorporated (SHV) companies rather than STV institutions. It has been based on models of the firm where there is a clear separation of owners, customers and managers. It is also based on the norm of owners having *equity* rather than *debt* contracts with their firm. As noted by Devriese, *et al* (2004), most of the corporate governance debate has focussed on the governance of non-financial companies and incorporated companies in particular. With notable exceptions, comparatively little attention has been given to the special governance issues in financial firms in general and mutuals and other non-SHV banks in particular. Making a general point with respect to banks, and from the perspective of Belgium, Devriese *et al* argue “corporate governance of banks differs from that of non-financial firms. In banks, debt holders are dispersed and non-experts, which limits the effectiveness of debt governance arrangements traditional in non-financial firms”. We find that these issues have more general relevance in the financial sector and with mutuals in particular.

There are several specific issues to consider most especially when comparison is made between optimal governance arrangements between mutual and incorporated firms:

- In whose interest are economic firms organised?
- The nature of agency problems, and the potential moral hazard associated with the split between ownership and control which is common to all forms of economic firm.
- How agency problems and moral hazard are best handled.
- The nature, form and effectiveness of the monitoring mechanisms of firms, and who undertakes costly monitoring.
- What are the *incentives*, *abilities* and *feasibilities* of effective monitoring of mutuals? This raises issues about the incentive structures for owners to monitor and discipline firms; about their technical capacity to do so (access to information and the ability to use relevant information, etc.), and whether it is feasible in practice for owners to monitor and control.

The paper is structured as follows. Part 3 considers some general analytical issues of relevance to corporate governance in the context of what will be termed the *Agency Paradigm.* This is followed in Part 4 by more detailed consideration of governance issues in financial mutuals.

3. An analytical framework

3.1. The economic firm

Our starting point is that mutuals are economic firms, i.e. organisations which use resources to add value in the creation of goods and services. In this regard, a mutual is one amongst many types of economic firm: sole proprietors, closed companies, partnerships, incorporated companies, Cooperatives, State-owned agencies, etc. Different types of firm often compete with each other in the same markets.

Mutuals are, therefore, one of many forms for organising economic activity. Each type of firm has its own strengths and weaknesses, which is why different organisational forms are able to co-exist (as in the building society and life assurance sectors in the UK and Savings Banks and incorporated banks elsewhere in Europe) and sometimes in direct competition with each other. Although different types of firm perform the same economic role, there are key differences between them:

- in their ownership structure: who owns the firm (e.g., as between individual and institutional ownership);
- the capital structure of the firm;
- the marketability of ownership stakes;
- in their ultimate business objectives and, in particular, whether they are shareholder-driven or focus on the interests of a wider array of stakeholders;
- the nature of ownership stakes (e.g. as between, for instance, tradable shares or liquid deposits);
- who takes the residual risk in the firm;
- how principal-agent problems are handled when there is a split between owners and managers;
- to whom managers are accountable and how they are made accountable for their actions;
- how ownership of the firm may change (e.g. mergers, take-overs etc.).

These are issues common to all firms but are handled differently in different types of economic organisation. If economic firms are not homogeneous the question arises as to whether optimal governance arrangements will be the same for all firms not the least because these differences have implications with regard to the disciplining power of the capital market and the role of the market in corporate control.

More formally, any firm is a set of contracts among the various factors of production, agents or "stakeholders" within the organisation. Clearly, within this paradigm there are many alternative ways in which these contracts can be structured and the mutual form is simply one amongst many possible corporate forms. A key difference between a mutual and an incorporated firm is that in the mutual the customers are themselves the owners of the firm whereas there is a separation of the two in the case of incorporated banks. This raises particular corporate governance issues.

A key issue is whether a firm's behaviour is determined more by ownership structure and corporate governance arrangements as opposed to competitive conditions in the markets for goods and services. In many ways the latter is more powerful than the former, and strong competitive conditions in markets may at times alleviate some of the problems implicit in less than perfect corporate governance arrangements of whatever type of firm is being considered (Nickell, 1996 and Heinrich, 2000). The discipline of competition in the markets for what firms supply is more powerful than particular corporate governance arrangements. In the hypothetical world of perfect competition in all markets, issues of corporate governance would be of second-order importance (if important at all) in terms of what really matters: the efficiency in the allocation of resources, and the efficiency in the use of resources. However, corporate governance issues are of significance because the ideal model of perfect competition does not exist in practice.

3.2. Origin of governance issues: The agency problem

Agency problems (potential conflicts of interest between managers, owners and customers of firms) can arise in any organisation in which there is a separation of decision and risk-taking functions: in the case of mutuals between the management and the Members, and in the case of incorporated banks between management and shareholders. This particularly arises when important decision agents do not bear a substantial share of the wealth effects of their decisions (Fama and Jensen, 1983). A potential moral hazard arises as managers may be induced to behave in their own interests rather than those of the owners. While there is a wide variety of different types of economic firm, the common corporate governance issue is how owners (residual claimants) or shareholders ensure that managers protect their interests.

The "agency problem" arises because contracts are necessarily incomplete: it is not feasible to set down in advance a set of complete contracts that specify courses of action for each stake-holder in all conceivable future

circumstances. Hart (1995) notes that corporate governance issues arise in particular when agency problems arise within a firm, and when transactions costs are such that the problems cannot be dealt with through explicit contracts. Also in this context, Fama and Jensen (1983) argue that agency problems arise because contracts are not costlessly written and enforced. Agency costs also include the value of any output lost due to the fact that the costs of full enforcement of contracts are greater than the benefits. Clearly, therefore, agency problems can arise in both incorporated and mutual financial institutions such as UK building societies and life assurance institutions.

With respect to corporate governance arrangements, the central idea is that owners of firms (whether they be shareholders of a company or Members of a mutual) delegate to management the job of running the firm and operating it in the owners' interests. In particular, management are supposed to pursue policies which maximise the benefit of owners. This amounts to maximising shareholder-value in the case of incorporated companies. In turn, the shareholders/owners monitor and control management to prevent them exploiting their advantageous position. The question arises as to whether, in practice, owners can effectively monitor and control management, and whether this varies between different types of firm.

There are three complications with respect to "maximising value" (the ultimate business objective of all firms) in the case of mutuals: (1) there is no formal separation between owners and customers, (2) the concept of "ownership" is less clearly defined, and (3) it is less clear what "maximising owner value" means in a mutual and what owners' ownership rights precisely are. In this last respect, there is no obvious parallel in a mutual to "maximising shareholder value" in an incorporated company.

A key element in this debate typically centres on the differences in ownership structure and the often-alleged greater scope for managers of financial mutuals to engage in rent-seeking or expense-preference behaviour. In other words, it is typically asserted that agency costs are potentially more serious in mutuals than in incorporated companies because the owners (investors and borrowers) of the former have less influence on managers than do their equity shareholding counterparts in incorporated companies.

3.2.1. An agency paradigm

Principal-agent problems can typically be addressed via three general routes: incentives (incentive compatible contracts), monitoring and regulation. In this context, issues of governance are to be considered in the wider context of the nexus of *influence*, *control*, *protection*, and *sanction* with respect to agency problems, and the various mechanisms that are available to achieve them. In what might be termed the *Agency Paradigm* several mechanisms have emerged to deal with potential agency problems:

- **Exit**: dissatisfied shareholders in an incorporated company sell their ownership stake which may have an impact on the share price, or Members of a mutual liquidate their stake by withdrawing funds or cancelling contracts.
- **Voice**: shareholders exert pressure on management to pursue correct policies. See, for instance, Zeckhauser and Pound (1980).
- **Governance arrangements** and the mechanisms through which management is held accountable to owners.
- **Labour market: t**he labour market in executives can be a disciplining factor to the extent that managers seek to enhance their personal market value by creating a reputation for success (Fama, 1980).
- The **market in corporate control**: the take-over market can exert pressure on management to be efficient and pursue policies that maximise shareholder-value, (Grossman and Hart, 1998, Jensen, 1988).
- **Capital market pressure**: price signals indicate shareholders' and creditors' views about the worth of the company and the quality of management and business strategy, and also determine the cost of capital and debt. This has been discussed with respect to the debt market and the threat of bankruptcy (Jensen, 1986) and the monitoring by debt holders (Hoshi, et. al., 1990). Holmström and Tirole (1993) also consider the monitoring by financial market analysts.
- **Rating Agencies** assess the credit-stranding of debt issuers.
- **Regulation** through which, in some areas, the behaviour of management is constrained by prudential and conduct of business regulation and supervision.
- **Sanctions** that may be imposed by regulatory agencies.
- **Publicity:** the behaviour of management and the business operations of the firm are scrutinised enabling stakeholders to make informed judgements about the firm.
- **Competition** in the markets in which firms operate can also ensure firms are under pressure to maintain efficiency.

Those who participate in the process of observing the behaviour of a firm and forming judgements in the light of it are described in Llewellyn and Mayes (2004) as "stake-holder monitors".

With respect to incentives within the incorporated firm, there are several general mechanisms designed to encourage management to behave in the interests of the owners:

- Salary incentives that align the interests of shareholders and managers. Examples include compensation packages related to the performance of the share price (Baker et al. 1988 and Kole, 1997).
- Share options and share ownership by executives (Jensen and Meckling, 1976) so that the interests of managers and owners are aligned.
- Executive presentations, discussions and regular contact with institutional shareholders. Mallin (1978) notes that British clearing banks individually have a close relationship with their institutional investors, and that regular meetings are held during the year on such issues as current and future strategy, quality of management etc.
- An active employment market for senior executives whose salary may be determined by past success and performance in other firms.
- If a bank is a major stakeholder in a firm, it can influence management by the availability and terms of credit and the incorporation of covenants in loan contracts.

Different elements of the *Agency Paradigm* are relevant for different aspects of a firm's business and may operate differently as between incorporated institutions on the one hand, and mutuals and other STV institutions on the other. Thus, for instance, while capital market pressure may be powerful in disciplining incorporated companies, it is considerably weaker (if relevant at all) in the case of mutuals which do not have tradable ownership stakes.

When considering optimal governance arrangements for different types of firm, a *governance matrix* can be constructed with the types of firm (mutuals, Cooperatives, partnerships, incorporated firms, etc) on one axis and the components of the *Agency Paradigm* on the other. The matrix can be constructed in such a way as to identify the relative importance of each mechanism for each type of firm. This can also highlight the nature of the trade-offs within the paradigm and can identify what priorities need to be established for each type of firm. The central point is that optimal governance arrangements are likely to vary between different types of firm dependent upon, *inter alia*, their ownership and capital structure, their business

objectives, tradability of ownership stakes, and the other elements within the paradigm.

To some extent there is a trade-off between the different components of the *Agency Paradigm* implying that weakness in one area may need to be compensated by stronger elements elsewhere. Thus if some elements are weak or non-existent in the case of mutuals, compensation may be needed through other routes. In particular, and as argued below, the absence of an effective market in corporate control suggests that corporate governance mechanisms may need to be stronger in mutuals.

3.2.2. Agency paradigm mechanisms

A central issue is the exit-voice dichotomy: in the absence of effective voice (i.e. ability to change the behaviour of a firm and its management) stakeholders may have the exit option. In the case of incorporated companies, shareholders are able to sell their ownership stakes in the market. In the case of mutual building societies, Members are able to withdraw funds from the Society. The mechanisms within the *Agency Paradigm* may be characterised as internal or external: the former includes voice, governance arrangements, and accountability mechanisms, and the second includes the influence of the capital market, the market in corporate control, the role of rating agencies, and competition in product markets.

Exit
The theory is simple to state: a dissatisfied Member or shareholder has the simple option of withdrawing from the firm. In the case of depositors, for instance, this can be done at low cost. Equally, a shareholder with a tradable ownership stake in a firm has the option of selling the stake in the secondary market. However, in some areas (such as where long-term contracts are involved including life assurance or personal pensions) while the option exists in theory, the costs (such as penalties) may be prohibitive to the extent that it effectively removes the exit option as a realistic possibility. Thus the exit mechanism may not be universal and will be dependent upon the transaction costs involved.

Voice
A major determinant of interval v. external monitoring and control is the structure of stakeholders' incentives, ability and feasibility to exercise voice. This in turn is powerfully influenced by the degree of concentration or

dispersion of ownership. Monitoring is a costly activity and hence there must be a sufficiently strong incentive (potential reward) for owners to incur these costs. When ownership is dispersed (a large number of shareholders with no dominant holdings) incentives are weak, ability to control is low, and the feasibility of control is weak. In the first case, no individual small shareholder has an incentive to monitor because his or her stake is low because the individual bears the full cost of monitoring but reaps few of the benefits. There would also be uneconomic duplication if all small shareholders were to conduct their own monitoring. This creates the standard free-rider problem: all seek to gain the benefit (but not incur the cost) of the monitoring activities of others. Expertise is also likely to be low as small stake-holdings make it uneconomic to acquire the necessary information and expertise to conduct effective monitoring. It is also not feasible to exercise control as, in practice, voice is not heard when the sanction that can be imposed by a small shareholder is weak. The existence of a large number of small shareholders also makes it difficult to organise coalitions.

It is also the case that the perception amongst Members of mutuals that they are in fact owners with ownership rights is weak as, in practice, most regard themselves exclusively as customers.

On the other hand, the problems of voice do not arise so powerfully when ownership is concentrated: incentives are strong, expertise can be gained, and feasibility is high. Concentrated ownership can create efficient internal monitoring and control and alleviate potential agency problems and moral hazard. The voice mechanism is potentially powerful when ownership is not diffused. Active shareholding becomes feasible when either ownership is concentrated in a small number of large shareholders who are willing and able to commit resources to monitoring and control, and who have incentives to do so, (Shleifer and Vishny, 1986). Large shareholdings (as in Germany and Japan) may, therefore, mitigate agency problems. Having shareholders represented on the Board of Directors may have the same effect. There is also evidence that, having non-executive Directors on the Board (as advocated by the Cadbury Committee) tends to improve company performance (Baysinger and Butler, 1985; Weisbach, 1988). There is evidence that the turnover of Board members in poorly performing companies tends to be greater when there is a high proportion of outside (non-executive) directors (Franks et al., 1995).

Governance arrangements

Corporate governance structures relate to: 'institutional arrangements which are designed to control relationships between the various stakeholders in firms, and which affect the actions of different stakeholders' (Gelauff and den Broeder, 1997). Specific corporate governance arrangements can influence the performance of firms (whether they be mutual or incorporated) in several ways. Mayer (1996) identifies five channels: (1) through the incentives they create, and in particular the extent to which they align interests in the principal-agent relationship between owners and managers; (2) through discipline effects (i.e. whether particular corporate governance arrangements facilitate the monitoring and disciplining of managers); (3) via re-structuring of companies through changes in ownership stakes; (4) via finance and investment (e.g. the incentives for, and the role of, debt and equity finance), and (5) the extent of commitment, i.e. whether stake-holders in the firm have an incentive or ability to develop long-term commitments.

The market in Corporate Control

A major difference between financial mutuals and incorporated banks relates to the market in corporate control (take-over market). With respect to the external mechanisms within the *Agency Paradigm,* many analysts argue that, while the operation of internal corporate governance mechanisms in public companies is far from perfect, this is at least partly mitigated by an active market in corporate control. In this respect, there may be something of a trade-off between internal and external mechanisms. However, when analysis is made of the way the take-over market works in practice, it is found to be far from the ideal textbook case (see Holmes and Llewellyn, 1997).

The basic theory behind the market for corporate control is simple enough and is outlined succinctly in Scharfstein (1988). The take-over market disciplines management to be efficient and to maximise shareholder-value. This is because if they do not do so, the share price falls and this gives an opportunity for an alternative management team to make a bid for the company because they believe they can manage the resources of the target company more efficiently. Because of this they can afford to pay a higher price for shares than the prevailing market price. In theory, resources in the economy end up being managed and controlled by the most efficient management teams. It is largely the *threat* of take-over that acts as the discipline on management. In addition, actual takeovers can, in some cases, enhance the interests of shareholders because of the benefits that may derive from economies of scale, synergies between companies, superior management, or superior business strategies of the purchasing firm. In effect,

the market is for the control of the resources embodied within the company. Furthermore, if the share price is undervalued because of the weak performance of the incumbent management, rival bids can be made for control of the company's equity. In effect, competition develops among rival teams and, in theory, resources end up in that team which can manage them most efficiently (Ruback, 1988).

It is frequently alleged that a major weakness of the mutual form in UK building societies and Life Offices is that, as there is no market in ownership, there is no scope for capital market discipline to be exercised. However, heroic assumptions need to be made before we can be confident that the absence of a market in the ownership of mutuals creates a serious problem. In fact, it is largely only in the Anglo-Saxon world that this argument would be used at all: it is not the norm in many economic systems and most notably not in Germany and Japan. The position has been put well in a *Financial Times* leader (February 10th, 1996):

> "Since many takeovers fail to achieve adequate returns for shareholders and some fail disastrously, it would seem logical to expect the shares of an acquiring company to go to a bigger discount. The fact that they do not reflects not merely the triumph of hope over experience, nor the incantations of merchant bankers and financial PRs, but the stock market's bias for action… In the case of mergers, shareholders of the acquiring company must satisfy themselves that there are real potential gains to be made from the combination, with a probability of success great enough to offset the generally unfavourable outcome of such transactions."

Overall, a sense of proportion is needed when considering the inefficiency consequences of not having an active market in corporate control in the mutual sector. Nevertheless, whatever the outcome of actual takeovers and mergers might be in practice, the threat of such activity acts as a potentially powerful discipline on management as they stand to lose control of the firm and the potential income streams embodied within it.

Regulation

Regulation and official agency supervision has a role in addressing potential agency problems and is one of the components in the *Agency Paradigm* as described above. As put by Devriese, et. al. (2004):

> "the high proportion of debts in the total liabilities (of banks), and the resultant high leverage, facilitate risk-shifting by shareholders. Hence there is a need for a representative of depositors to 'mimic' the role taken by debt holders in non-financial firms. Typically, this role will be performed by a regulatory and supervisory authority"

Thus the goal of official agency regulation and supervision in constraining the behaviour of financial firms is to complement other mechanisms designed to limit risk-taking and potentially hazardous behaviour, and this includes minimising agency costs.

A key issue is the precise role that regulation should have in the overall *Agency Paradigm.* One role is to correct for weaknesses elsewhere in the paradigm. It is clear that the agency problem of asset substitution (see below) is closely related to the issue of financial regulation and this is illustrated in recent theoretical analysis in this area. Dewatripont and Tirole (1994) and Tirole (1994), for example, highlight the explicit corporate governance role of financial regulation. In the case of incorporated companies, there may be an incentive for management, acting in the interests of the shareholders, to take excessive risks at the expense of depositors, particularly when the firm is performing badly. A strategy of "gambling for resurrection" makes sense to shareholders when the value of existing equity is low. The moral hazard is that there may be incentives to take excessive risks as the value of equity falls. This potential for excessive risk taking in incorporated financial institutions may also be reinforced by the well-known moral hazard problems introduced by either explicit or implicit deposit insurance.

Regulation can be used to offer protection to stakeholders in the absence of effective protection from other components within the *Agency Paradigm,* and can require certain governance arrangements to be put in place. This means that weaknesses in the *Agency Paradigm* (e.g. in voice) can potentially be offset or alleviated by regulatory intervention designed to protect stakeholders.

However, regulation may have the unintended consequence of blunting the incentive for private monitors to incur the costs of monitoring. There are several possible reasons for this: (1) the regulator might be perceived as having superior information, (2) private monitoring might be viewed as only duplicating what is already being undertaken by official agencies (the free-rider problem), (3) official agencies have economies of scale that are not

available to private monitors, (4) official agencies might have superior expertise, and (5) official agencies usually have the power of enforcement. The moral hazard is that this lowers the incentive for others to monitor.

If, for any reason, there is a perception that a financial firm will somehow be rescued in the event of distress, or that compensation will be forthcoming in the event of failure, the incentive to incur monitoring costs will be low. The general point is that incentives to monitor (and incur the costs of doing so) rise as the costs of doing so decline, and rise the greater are the losses in the event of a failure. The key, therefore, is to lower the costs and raise the benefits of private monitoring.

Competition

Competitive markets are themselves a major disciplining mechanism on management**.** Baumol *et al* (1989) go further and argue, in the context of the US mutual fund industry, that competition between funds was the main factor restraining administration charges. In practice, competitive pressures rather than corporate structure are likely to dominate the behaviour of financial firms most especially when mutuals and incorporated firms operate in the same markets in competition with each other (Drake and Llewellyn, 1997). It has also been argued that the co-existence of mutuals and incorporated banks in the same market place can intensify competitive pressures for the benefit of consumers (Llewellyn, 1997). Field (1996) has also argued that the participation of new mutual associations could “add yet a new cutting edge to competitive forces” in the pensions sector. However, a market may be very competitive (as measured in normal ways) but competition may nevertheless not be *effective* in the market place either because it is difficult to make comparisons between different firms’ products (information problems and complexity), or because the transaction costs of switching are high, (Llewellyn, 2006). .

4. The *agency paradigm* and corporate governance in practice

In this part of the paper, distinctions are made between different types of firms and the governance issues that follow from these distinctions. The analysis is conducted within the general framework of the *Agency Paradigm* of which governance arrangements are a part.

4.1. Structure of the argument

The analysis of corporate governance in mutual financial firms is set within a broader framework considering the special characteristics of financial firms, and mutuals in particular. The ultimate issue is whether corporate governance principles and optimal governance arrangements are homogeneous to all firms. The argument here is that they are not, and that optimal governance arrangements for financial firms and industrial companies are likely to be different (because of the particular characteristics of financial firms), and also different between non-incorporated financial institutions (including mutuals) and SHV banks. The structure of the analysis is summarised in figure 1.

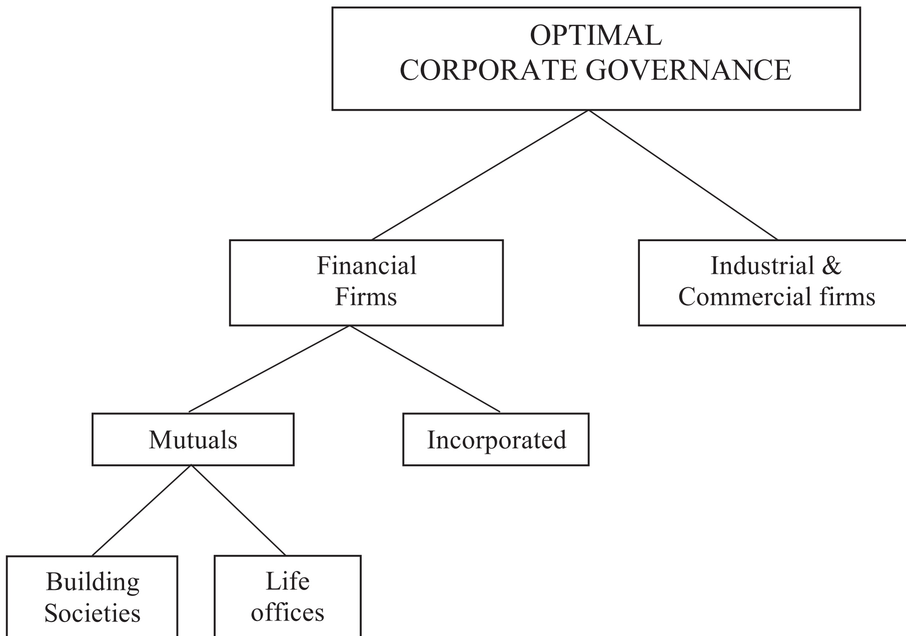
In particular, financial firms have special characteristics that do not apply to industrial and commercial companies and which may influence optimal governance arrangements. Within the financial sector, there are also unique characteristics of mutuals as compared to incorporated financial institutions. Even within the mutual sector, life offices (which issue predominantly long term contracts to customers, and where transactions costs of exit can be high) differ from building societies (which accept predominantly short-term deposits from Members to fund long-term mortgages).

4.2. Special characteristics of financial firms

There are significant differences between financial and non-financial companies (irrespective of the distinction between mutuals and incorporated financial institutions) and to an extent that influences optimal governance arrangements:

- Financial firms (and especially life assurance institutions) operate on a relationship rather than a transaction basis, and sometimes write contracts with long duration. This raises customer exit costs and the feasibility of control because customers are to some extent "locked in" to their contracts. This has governance implications in the case of mutuals because owners and customers are the same.
- Post-contract behaviour of financial firms affects the value of the contract to the consumer. This creates the potential for opportunistic behaviour and gives rise to a further need for monitoring. No amount of information available to consumers at the point of purchase can guard against this potential hazard. This is part of the reason why financial services firms are subject to official regulation and supervision. This has a governance dimension in the case of mutuals again because owners and customers are the same.
- The nature of the business is often complex and this may be especially significant with life assurance institutions.
- There is often a fiduciary responsibility towards customers in that the firm is managing the wealth of customers on a delegated basis.
- By the nature of their business, many financial firms are particularly opaque.

Figure 1



- Many financial firms have a systemic dimension in that the failure of an individual firm may create instability in the financial system as a whole: in the context of banks, the social cost of failure is greater than the private cost (Llewellyn, 1999). This in turn might reduce private monitoring below the optimal level because the external costs of failure would not enter the incentive structure of private monitors.
- Financial firms are regulated and supervised by official agencies. This may create a moral hazard and limit private monitoring if private stakeholders judge they would only be duplicating the monitoring activity of the official agency.

In addition, there are significant differences between (some) financial and non-financial services and products. These particular special characteristics include:

- They are often not purchased frequently and hence the consumer has little experience or ability to learn from experience.
- If the firm becomes insolvent during the maturity of the contract, the value of the contract may be lost which is not the case with most other goods and services.
- Information on reliability is difficult to obtain.
- Value is not immediately clear at the point of purchase: the consumer cannot know if a bad product is being purchased because costs and the rate of return emerge over a period of years.
- There is a lack of transparency: it is difficult to verify the claims being made by the financial firm.
- It is often easy for a financial salesperson to conceal relevant information and/or mislead the consumer.
- It is often difficult to detect misrepresentation at the time of purchase.
- The product cannot be tested ahead of purchase.
- The full cost of the product may not be known at the point of purchase and can sometimes be concealed from the consumer.
- It may be a long time (if at all) before the consumer is aware of the value and faults of a financial contract. This limits the power of reputation as an assurance of good contracts. Even if, in the long run, reputation is damaged by bad behaviour, consumer wealth is impaired in the meantime.

All of this means that consumer trust is more important in financial services than in most other industries (Llewellyn, 2006a). In the case of mutuals, these conditions also raise governance issues because, given the nature of mutuality, customer contracts create ownership stakes. In the case of life

assurance mutuals in the UK, an investment in a life assurance product creates an ownership stake, just as does a deposit at a building society.

Because of these differences, the optimal balance between the different elements in the *Agency Paradigm* will be different in financial firms (whether mutual or incorporated) than in industrial and commercial companies, and also different between incorporated financial firms (where transactions do not create ownership stakes) and mutuals where they do. In particular, comparatively more reliance is likely to be placed on regulation and official supervision because the optimal amount of supervision will be greater than the amount the private market is likely to supply.

4.3. Mutuals v. incorprated firms: key differences

The major differences between mutuals and incorporated financial firms relate to ownership structure, the extent to which owners and customers are separate, whether ownership rights are based on debt or equity contracts, the voting rights of owners and the extent to which these are related to the size of ownership stakes, the marketability of ownership claims, and the disciplining role of the capital market and the market in corporate control.

In the case of mutuals, each Member has a non-exclusive claim to residual net worth (non-exclusive in the sense that typically new Members can join on equal terms to those of existing Members). A typical characteristic of mutual financial institutions is that ownership claims are severely attenuated. Each Member has a non-exclusive and non-marketable claim to residual net worth. In the case of building societies, for example, the reserves of the Society will have been accumulated over many years from the profits generated by the resources provided by previous Members. Nevertheless, the 'notional' ownership of this residual net worth will rest with the current Members with new Members being able to join on equal terms simply by, for example, making a deposit. It is in this context that building society Members have a non-exclusive claim on residual net worth.

The claims on residual net worth by equity shareholders in incorporated companies, on the other hand, are explicit and marketable. Furthermore, a new residual claimant must 'take over' the claims of existing shareholders by buying shares on the open market and the current value of the residual claim is reflected in the share price. Similarly, in the case of additional equity issues, the most common form is by rights issues where existing residual

claimants (current equity shareholders) are offered the option of buying additional shares in some proportion to their existing holdings at a specified price. It is in this context that equity shareholders in companies have both a marketable and exclusive claim on residual net worth which contrasts with the position of the notional residual claimants of mutual financial institutions.

Owners of mutuals are also the customers which, as put by Penrose (2004), implies that: "the persons with whom business is done are the persons for whom business is done". Each member has a non-marketable claim (because it would not be feasible to have a secondary market for non-exclusive claims). Furthermore, in the case of depositors or borrowers at a building society, the Members have debt contracts with the Society where the rate of return is not immediately determined by the performance of the Society. However, this must be qualified to some extent. Firstly, a more efficient Society might be able to offer better terms on deposits and loans. Secondly, in some cases (e.g. with-profits life assurance contracts) there is a direct link between the mutual's performance and efficiency and the rate of return earned by Members.

The key differences in capital structure between the two are that: a mutual has no externally-held risk capital (its capital is built up from accumulated profits); there are no specialist outside risk-takers which supply equity capital and, leaving aside subordinated debt, the only source of capital for a mutual is the profits of the organisation. As Penrose (2004) argues with respect to life assurance mutuals: "it is policyholders who are the source of risk capital for the enterprise" (chapter 20, Para 51). Several implications follow from this:

(1) There is no (or only weak) discipline exerted by the capital market.
(2) With a mutual, profits are either taken into reserves and add to the capital base (the case of building societies) or, in the case of life assurance mutuals, are distributed to with-profits policy holders. An incorporated financial institution, on the other hand, distributes a proportion of profits to external shareholders.
(3) In theory, mutuals enjoy an "efficiency advantage" by virtue of their capital structure and the absence of externally held capital that needs to be remunerated (see Drake and Llewellyn, 2003).
(4) The cost of capital in an incorporated financial firm is a claim on revenue and exogenously determined in the capital market.
(5) As the capital of an incorporated institution is tradable, there is an active secondary market in ownership claims which does not exist with a mutual.

(6) For the same reason, there is an active market in corporate control in the case of incorporated institutions but not in mutuals or most other non-SHV financial institutions.

In the case of financial intermediaries such as building societies and life assurance companies, there is no *necessity* to have a specialist supplier of risk/equity capital independently of the customers. This is because depositors themselves provide the wherewithal for the "bank" to make loans. It could be argued that, if external suppliers of capital (shareholders in the case of incorporated financial institutions) are not *necessary*, having them stand between different sets of customers (e.g. depositors and borrowers in a building society) unnecessarily increases the number of stake-holders in the firm. It may also add to the complexity of agency relationships, may create potential (and unnecessary) conflicts between customers and shareholders, and may raise the cost of financial intermediation. This last-mentioned arises because there is a class of stakeholders which needs to be remunerated but which is not *necessary* for the basic function of the firm to be undertaken.

In the case of mutuals, there is no such evident conflict because Members (owners) are also the customers. Nevertheless, conflicts may arise because of the different interests of different Members. This became apparent in the case of Equitable Life – the life assurance company in the UK and which became the subject of an official enquiry as thousands of Members were penalised by several thousands of pounds because the mutual life assurance office offered guarantees to a sub-set of customers which in the event could only be honoured by penalising other Members.

Three general criticisms are frequently made of the mutual form of economic organisation (whether in building societies or life assurance offices): (1) the objectives of the mutual are difficult to define, and are ambiguous; (2) there is a potentially serious corporate governance deficit in that the wide dispersion of ownership rights means that management is insufficiently accountable to owners, and the monitoring of managements by owners is weak; and (3) the absence of tradable ownership rights means that the management of mutuals is not subject to the disciplines of the capital market (through the signal effects of share price movements), or the market in corporate ownership and control. In other words, corporate governance and accountability mechanisms are likely to be weak, and these are not compensated for by an active market in corporate control.

4.4. Governance issues in mutuals

It has been argued above that agency problems arise in any large organisation (financial or non-financial) where there is a distinction or separation between the decision-making and risk-bearing functions. In such organisations, the decision process is generally conducted by professional managers whose objectives are typically different from those of the residual claimants – such as equity shareholders in incorporated companies and Members in mutual building societies (Smith, 1904; Berle and Means 1932; Jensen and Meckling 1976; and Fama and Jensen, 1983).

Because of the properties of the mutual firm outlined earlier, mutuality raises specific corporate governance issues and the role of governance within the overall *Agency Paradigm*. Drawing together the strands of earlier analysis, these issues may be summarised as follows:

- Corporate governance is less clearly defined in mutuals partly because the firms' objectives are less clearly defined. There is no unambiguous equivalence in a mutual to maximising shareholder value in an incorporated financial firm.
- Transparency is a particular issue in the case of mutual financial firms for several reasons including:
  - there is no clear "bottom line" objective for mutuals. Objective-setting and performance measurement are less straightforward;
  - as a consequence, conflicts of interest between managers and owners in strategic decision making are less easily identified;
  - as the ultimate business objectives are not as clear-cut as in the case of maximising shareholder value in an incorporated financial institution, it is more difficult to create management incentives (such as through share options) which are aligned with owners' interests.
- A key feature of financial mutuals is that voting rights conferred by membership are typically not proportional to the size of ownership stake, and cannot be accumulated by purchasing votes in the market. Hence, the ownership rights inherent in a one-member, one-vote system are necessarily widely dispersed with no individual or group being able to build up a controlling position. Paradoxically, ownership stakes are proportional to the size of the stake but voting rights are not.
- Member voice (and the incentives for owners to exercise monitoring and control) is weak because of weak incentives to exercise it, and as individual ownership rights are small, the costs of monitoring may be disproportionately high relative to the benefits. Also, there will be none

of the economies of scale enjoyed by institutional investors in incorporated firms. Members have weak *incentives*, *feasibility* and *ability,* and in effect, a "free-rider" problem emerges.

- Voice may be weak because, in some cases, dissatisfied Members have the easier option of withdrawing funds and business though this may be limited in the case of life assurance institutions because of the long-term nature of contracts and high exit penalties.
- The owners of mutuals (Members) are in general non-expert in the affairs of the firm which limits the effectiveness of traditional corporate governance mechanisms.
- There are no individual large (or institutional) shareholders who have an incentive to monitor and control. Membership of mutuals is highly dispersed (a large number of small owners) and there is no concentration in ownership stakes with the result that the incentives, expertise and ability to exercise voice are severely constrained. Dispersed ownership also makes it difficult for members to form coalitions. Blair (1995) argues that institutional shareholders in incorporated companies have economies of scale in monitoring and gain experience and expertise through monitoring many firms.
- In the case of incorporated banks, the shares (ownership claims) have a market value which is immediately observable and which creates a continuous re-valuation of the company. In the case of a mutual, on the other hand, there is no market in ownership claims and hence no price signals to guide management and alert owners and other stakeholders. Mutuals are not subject to the stock market discipline of the price of their equity whereas the cost of capital is a powerful discipline in the incorporated sector.
- There is no effective market in corporate control in the mutual sector as there is no externally held capital and no tradable ownership rights that can be bought in a hostile bid.
- It many cases, Members of mutuals do not know they are the owners with ownership rights that can be exercised. The generality of Members regard themselves as customers rather than owners and their concerns are those of customers and not owners.
- In the case of incorporated financial institutions, major investors are informed by senior management about developments within the company, its performance and planned strategy. Many companies have Investor Relations departments, and large institutional shareholders are able to take the initiative by demanding private meetings with senior management. Given the dispersed nature of ownership, this is clearly not feasible in the case of mutuals.

- Unlike the case of mutuals, the financial interests of equity holders in the efficiency of managers of incorporated firms is proportional to their share ownership and is direct since, in theory, the value of shareholder claims is linked to the company's profitability. This suggests that large institutional shareholders have a strong interest in monitoring and influencing the companies in which they have invested.
- Mutuals are not rated systematically by rating agencies;

In general, the voice of Members in a mutual is likely to be less powerful and influential. Birchall (2001), for instance, argues as follows: "The mutuals, in common with mutuals the world over, long lost touch with their members, treating them merely as customers and playing down their democratic rights to be uninvolved". This is a central problem: both Members themselves and the management of mutuals have come to view Members as customers rather than owners, although at least some building societies have started to recognise the significance of customers also being Members.

It is generally the case that Members of mutuals are not in practice active in governance arrangements irrespective of their legal rights: there is usually only a very small attendance at Annual General Meetings, it is difficult for Members to communicate with the managers, apathy is often a characteristic, it is not clear that Members regard themselves as "owners" with ownership rights, Members are usually subject to inertia, the costs of exercising rights are often high, Members may feel they have insufficient understanding of the issues, and "free-rider" strategies are often rational. In which case, while mutuals might be "mutually owned" they are not "mutually controlled".

Members are uniquely placed in that they are the owners of a mutual and without Member involvement, a governance deficit emerges. Evidence found by the Myners enquiry is that the majority of Members of mutuals are not interested in becoming more involved in corporate governance. Nevertheless, the long-term nature of the products offered by financial mutuals (e.g. mortgages and life assurance) means that the Members have a particular interest in governance. The Myners Report made a series of recommendations to encourage Members to exercise their membership rights, and to encourage the management of mutuals to engage with the membership and to facilitate more information disclosure, promote dialogue with Members, and facilitate discussion among Members. Just as incorporated companies have investor relations department, mutuals are to be encouraged to develop explicit member communications facilities.

All this means that there is ample scope for mutuals to be inefficient and to adopt hazardous behaviour. There are, therefore, particular agency costs in mutuals deriving from weak Member control. In practice, Members in a mutual do not have the same ownership rights as do shareholders: they cannot be sold in a secondary market; they can be unlocked only via a conversion to an SHV institution (as has happened with some of the large building societies in the UK and elsewhere); the management of the mutual may also consider the interests of future generations of owners (Members) as well as the current cohort, and voting rights are not proportional to the size of the ownership stake.

However, this general conclusion needs to be qualified as, in practice: (i) there is no systematic evidence that these agency costs are significant in the case of UK mutual building societies and life assurance mutuals, (ii) there is no evidence that they have adversely affected the efficiency and performance of mutuals (on the contrary, mutuals often exhibit superior performance), and (iii) equally, there are agency costs in incorporated financial institutions that are similarly not perfectly addressed. Regarding (i) and (ii), it seems to be the power of the competitive market place (savings and mortgages) that acts as the ultimate discipline.

4.5. Might governance be superior in mutuals?

Some of the mechanisms within the *Agency Paradigm* are less powerful within mutuals than with incorporated financial institutions which is why it is alleged that the corporate governance deficit is more serious in mutuals than in other companies. However, there may be offsets. It can be argued, for instance, that mutual financial institutions are better able to address some agency problems than are their non-mutual counterparts. Four issues are considered: (1) the unique nature of the residual claim, and the exit option is potentially more powerful; (2) absence of capital market as a source of capital; (3) absence of shareholder/creditor conflicts, and (4) some particular governance arrangements.

Exit potentially more powerful

A significant feature of a mutual is the unique nature of the residual claims: specifically, that they are redeemable on demand, e.g., building society shareholders (investors) can simply withdraw deposits. Fama and Jensen (1983) point out that:

> "The decision of the claim holder to withdraw resources is a form of partial take-over or liquidation which deprives management of control over assets. This control right can be exercised independently by each claim holder. It does not require a proxy fight, a tender offer, or any other concerted take-over bid. In contrast, customer decisions in open non-financial corporations and the repricing of the corporation's securities in the capital market provide signals about the performance of its decision agents. Without further action, however, either internal or from the market for take-overs, the judgement of customers and of the capital market leave the assets of the open non-financial corporation under the control of the managers" (p 318).

The property rights literature suggests that the usual emphasis on factors such as: limited voting rights, poor attendance at AGM's, lack of owner Members on the board of directors, etc, in respect of mutuals is misplaced. In practice, as potential Member withdrawals imply a partial liquidation in a mutual organisation, this should generate a strong incentive to supply financial services on competitive terms and to provide a high quality of service (especially in a highly competitive environment).

In this context, Fama and Jensen's argument can be seen as an extension of the Hirschman (1970) *exit-voice* dichotomy. In mutual organisations, depositors/owners typically exhibit little Member *voice* (for the reasons outlined previously) but can exercise the easy and costless option of *exit*. In other words, it is easier and less costly for a Member simply to (almost costlessly) withdraw business (e.g. a deposit) and transfer it to a competitor than to seek to change the behaviour of the firm. This is a powerful discipline and is in some senses a more direct threat to managers since, when a depositor withdraws funds, the capacity of the mutual is immediately reduced, whereas the sale of an equity stake in an incorporated bank does not immediately influence the capacity of the firm though the share price might fall. In effect, the relative cost of exit compared with voice is lower than in incorporated SHV banks.

Absence of capital market option

A particular disciplining mechanism in financial mutuals is that they do not have access to external equity finance which makes them more reliant on retained profits for growth. If managers have growth maximisation as a primary objective (there is empirical evidence in the UK of links between growth and management remuneration, Ingham and Thompson, 1995) this will be consistent with profit maximisation (or at least with a strong profit motive) providing that capital adequacy ratios are potentially binding.

The capital structure of mutuals is such that the almost exclusive source of capital is retained profits. This implies that, not only is it more difficult for a mutual to expand through the injection of external capital, business mistakes that have the effect of destroying capital cannot be offset by external injections of capital. This might make mutuals more risk-averse than SHV banks because mistakes cannot be so easily rectified.

One non-executive director of a mutual life assurance institution in the UK argued to the Myners enquiry as follows:

> "Given that life mutuals operate in highly competitive markets, and with limited capital, it has of course been the case that they have faced strong pressures for effective market and economic performance"

As argued in an earlier section, competition is appropriately included as a component of the *Agency Paradigm* in the nexus of influence, control, protection and sanction with respect to potential agency problems.

Absence of shareholder/creditor conflicts

The debate over relative agency costs in mutual and SHV financial institutions tends to focus on standard agency problems, i.e., problems associated with the separation of decision-making and risk-bearing functions and manifested in problems such as management slacking and perquisite taking. A further agency problem, however, relates to the potential conflict between the holders of debt contracts and the holders of equity. Specifically, the nature of the debt contract dictates that if a risky (*ex ante*) investment produces high (*ex post*) returns well above the face value of the debt, equity holders will capture the gains while debt holders receive only their fixed contractual payments. If, however, the investment fails then, due to their limited liability, equity holders will face only limited downside risk while debt holders will face the same downside risk without any compensating upside potential. Thus, as shareholders have all the upside potential of risky behaviour, but only a limited downside loss, they may have greater incentives to encourage the firm to take more risk than do debt holders in the firm.

It follows that equity holders may have an incentive to see the firm investing in highly risky projects even though they may be value-decreasing for the firm, and this tendency may be exacerbated if equity investors have highly diversified portfolio holdings. This effect, generally referred to as the "asset substitution effect", is an agency cost of debt financing in incorporated companies.

It can be further argued that the presence of external shareholders in SHV financial institutions adds a further dimension to the agency problem by virtue of the potential conflict between the owners (equity shareholders) and depositors/customers. Clearly, in financial mutuals this particular aspect of the agency problem is absent as owners and customers are one and the same. As mutual owners have no direct claim on profits they have no incentive to prefer risky activities. .

Governance arrangements

In many cases in practice, mutuals seek to overcome the weaknesses of external disciplines by applying alternative mechanisms for internal governance. These include, for instance, a higher proportion of Non-Executives on the Board of Directors, greater use of Board committees compared with the norm for incorporated banks; fewer business links with companies (O'Sullivan and Diacon, 1996), and a greater likelihood of having remuneration committees than is the case with incorporated firms (O'Sullivan and Diacon, 1996). In addition, in the building society sector in the UK initiatives have been taken by some Societies to enhance Member involvement by, for instance, the creation of Member Panels, Member Parliaments to facilitate communication between Members, roadshows to enable communication between Members and managers, membership magazines to communicate information, Member meetings, and Member Directors. Many Societies have taken measures to enhance the engagement with Members.

4.6. The board of directors

The general role and importance of Boards, and in particular the composition as between Non-Executive and Executive Directors, are universal and have been addressed at great length in many recent reports in the UK and above all in the *Combined Code*. The arguments are not repeated here. However, most public discussion and reports have focussed on the traditional SHV company model and comparatively little attention has been given to the special position of mutuals. Because of the features of mutuals outlined in earlier sections, the role of the Board in monitoring management should be a more central feature of good corporate governance in mutuals.

For these and other reasons, the Board of a mutual has a particular role to represent the interests of Members both as owners and customers. The role and composition of Boards in mutuals is particularly important because, for

reasons outlined in earlier sections, corporate governance itself has a more central role in the *Agency Paradigm* and has a particularly powerful role in compensating for weaknesses in other mechanisms within the paradigm. In many ways, Directors (and most especially Non-Executive Directors) in mutuals have an important delegated monitoring role for Members.

Several implications follow from this with regard to the composition and skill set of the boards of mutuals including the greater importance of having a non-executive Chairman, and the need for a higher proportion of Non-Executive Directors on the Boards of mutuals than in SHV institutions. In the final analysis, the Board of a mutual is responsible and accountable to Members who are also customers.

The Myners Report in the UK argued that there need to be arrangements in place to ensure that boards of directors of mutuals are as accountable to the Members as is the case with boards of incorporated companies to their shareholders.

5. Concluding remarks

The structure of the analysis can be summarised as follows. Potential agency problems exist in all structures of firms whether they be mutual or incorporated which create potential conflicts of interest between various stakeholders and notably between owners and managers of the firm. We have established the concept of an *Agency Paradigm* which incorporates various components for *influence*, *control*, *protection* and *sanction.* There can be trade-offs within the paradigm such that, in principle, weaknesses in some of the components can be compensated by stronger forces in others. Optimal corporate governance arrangements will vary between different types of financial firm. With mutuals, external discipline (through the capital market and the market in corporate control) is weak compared with incorporated financial firms. On the other hand, while *voice* is comparatively weak in mutuals (and other non-SHV institutions), *exit* is potentially more powerful as it removes resources from the mutual which is not the case with an incorporated firm.

A central concern is that the absence of an effective market in corporate control in mutuals suggests that corporate governance mechanisms need to be stronger. And yet in many respects they are weak. The potential weakness in non-incorporated institutions is that both external discipline and effective governance arrangements and accountability are weak, and this is not compensated for by an active market in corporate control. The danger is that this can impose economic inefficiencies, and possibly a sub-optimal allocation of resources within an economy. For these reasons, more attention needs to be given to (the somewhat neglected issue of) corporate governance arrangements in non-incorporated financial firms whether they be mutual, Co-operative or State-owned. This is an issue that has been noted by the EU Commission in its recently published report on European Retail Banking (2007) which indicated that the Commission intends to address this issue in a subsequent enquiry.

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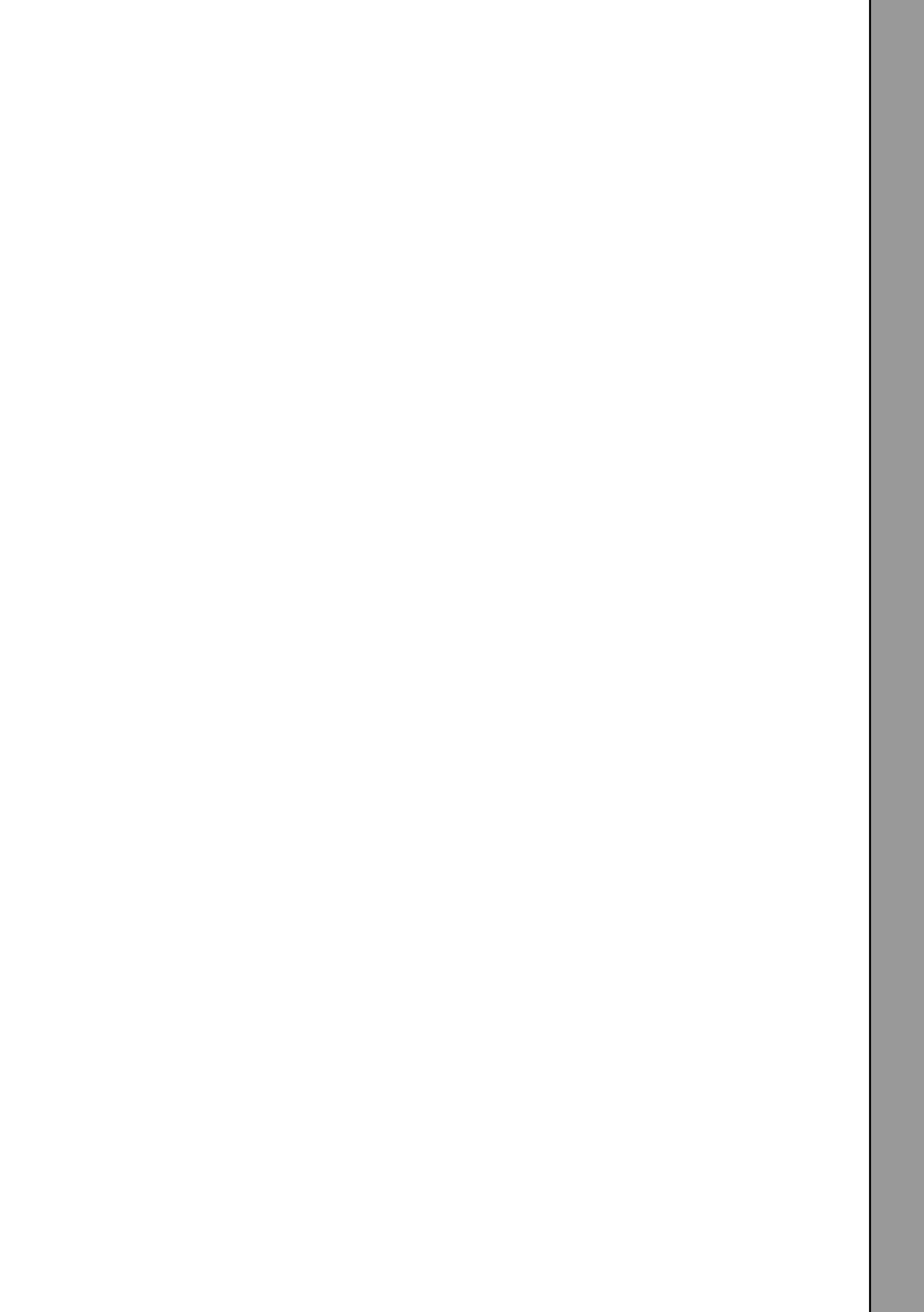

Corporate Governance in Emerging Market Banks[1]

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1. Executive Summary

Contrary to popular belief, corporate governance ("CG") does exist in emerging markets. While it is true that the equivalent of the Sarbanes-Oxley Act ("SOX") is not being enforced on a wide scale in any emerging market Fitch Ratings is aware of, notable improvements are being made, at least in the banks, where development of good CG often runs in tandem with progress in risk management controls and regulation. In this report, Fitch assesses CG in various emerging market banking systems, how this is developing and any impact this has on the ratings. It is important to note, that, while good governance in itself does not prevent fraud, it should make it easier to detect.

CG requires a separation of function between the board, executive management and audit, and implementation is key. The independence and authority of each function needs to exist in more than only legal form. Fitch has seen progress in implementation in most emerging markets over the past two years. However, economic conditions have been relatively benign, and the robustness of new CG in practice will only be tested in a downturn. Weak CG practices at any company are a negative rating factor and may serve as a cap on how high a rating can go, however strong its financial profile may seem.

The degree of governance in companies in a country goes hand-in-hand with the level of political governance. The identification and separation of powers and responsibilities between three branches of government create the necessary framework for CG at the company level to function. The degree of political governance will, to a great extent, be reflected in the ability of a market economy and companies in it to develop.

Before assessing the degree of CG at an individual bank, it is important to analyse the checks and balances that exist and those still under development in the banking system in question. Oversight of risk management by a bank regulator is highly influential in a bank's governance structure. For CG to be effective, a banking system requires the following:

- A functioning legal system;
- Independent regulators;
- Meaningful fines or sanctions and/or market forces that challenge and punish banks that do not play by the rules.

At all three tiers of governance (political, banking system, bank), the weaknesses that are most prevalent in emerging markets are:

- A high level of related party influence (a consequence of wealth and power being concentrated in only a few hands);
- An absence of challenges to the status quo due to lack of experience and expertise.

State ownership of the banks and/or direct influence on their operations is a major issue that can taint governance at all levels.

2. Introduction

This report follows earlier reports by Fitch on CG[2] and draws on a paper published by the OECD on CG in emerging markets[3]. The report is in two main sections. Part I gives a broad overview of the three tiers of governance and Part II looks at how CG is evolving region by region in various emerging market countries. Weak CG has had a direct bearing on the collapse or partial collapse of a number of emerging countries' banking systems. The good news for investors is that, while there is a wide disparity of CG among the emerging-market banking systems covered – from poor to quite good, in the main there has been a marked improvement in the past three to five years, following on from the crises in Latin America and Asia in the late 1990s, and, in central and eastern European ("CEE"), as a result of many countries starting to shed their state-control legacy and to develop functioning market economies. In most cases, this has emanated from a need to satisfy the demands of the international capital markets such that the banks can gain and continue to have access to them. This has taken two forms: listings on stock exchanges in developed markets and increased foreign-bank ownership and involvement in the banking systems (most prevalently in central Europe's transition countries). In other banking systems, better CG has, in part, come about from public pressure following banking system collapses (e.g. in some Asian countries) or the countries' desire for EU-accession as in some CEE states.

CG rules or guidelines for banks come from banking regulators and/or stock exchange listing requirements. CG codes from the latter tend to be voluntary and/or address listed banks only, thus excluding quite a large proportion of banks in some systems. Also, codes established in form may not make very much difference to poor governance in practice. In spite of a general improvement in implementation, there is still some way to go, and weak CG remains a constraint on Fitch's ratings for a number of banks in emerging

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[2] "Evaluating Corporate Governance: The Bondholders' Perspective", dated April 2004; "Sarbanes-Oxley Section 404: Fitch's Approach to Evaluating Management and Auditor Assessments of Internal Controls", dated January 2005; and "The Framework for Corporate Governance in Major European Banking Systems", dated April 2005, which can be found on www.fitchratings.com.

[3] OECD Development Centre Policy Brief No. 23 Corporate Governance in Developing, Transition and Emerging-Market Economies by Charles Oman, Steven Fries and Willem Butler, 2003.

markets, and ratings will only be upgraded once tangible improvement in CG becomes evident. However, as improvement in CG generally goes hand-in-hand with more general strengthening in risk and business management, it is rarely possible to pinpoint the impact of CG alone on a rating.

At the individual bank level, the agency applies the same structural approach to CG analysis as in developed markets, looking at: board independence and quality, oversight and the importance of related party transactions, the integrity of the audit process, acceptability of executive and director remuneration, differing ownership structures and transparency. However, before starting to look at these, bank analysis in emerging markets needs to take a step, or a few steps, back and look at governance at the macro political level and in the banking system as a whole. The areas to consider in this respect are detailed in Part One of this report.

Part Two of the report comments on the specific banking systems in several countries. It considers the historical development of CG within them, with a particular focus on bank ownership structures noting that most examples of weak CG in banks stem from their being owned by either the state or a family/conglomerate with extensive non-bank businesses – i.e. by interests that have other objectives achievable at the expense of the bank's profitability and resources.

3. Three Tiers of Governance

Political Backdrop

The struggle between two opposing forces in emerging markets dictates the development of governance from the top of the political spectrum down to the implementation of appropriate policies at bank branch level. These are:

- Powerful vested interests generally represented by just a few individuals;
- Public pressure, representing all interested parties.

While the latter can prevail over the former, this does not tend to happen in poorer countries where expertise and financial resources to implement effective representative political systems are scarce. However, once public pressure gains some international support, one way or another, things generally start to change.

For governance to function properly in a country, powers and responsibilities need to be separated between the following three branches of government:

- A representative legislature with oversight capabilities (i.e. an elected government to decide on the laws that best suit the country);
- A competent and accountable executive branch (i.e. public administration – civil service, police force);
- A fair and independent judiciary.

This aspect was well described in the OECD paper.

Governments in emerging market countries, especially those countries at the earliest stages of development, are often not representative of the majority of the population. Unrepresentative governments tend to establish – or only enforce – laws that serve the short-term interests of the individuals in power rather than interests of the country as a whole. Those in power may be different from those governing in name, as financial and military promises or threats may dictate what happens in practice.

Laws have no effect unless put into practice by objective administrators. A fully functioning civil service is a good means of doing this, backed by an

accountable police force and independent judiciary. However, in emerging markets (and indeed often in developed markets) corruption can be rife at this level of power. The most effective way to ensure that laws are entrenched into society, once the infrastructure for representative government is in place, is for the population to understand their purpose, believe in them and work as "good citizens" to ensure they abide by them. This is down to education and, particularly, experience. In developed markets, this process has been instilled through centuries. It is generally not something that can happen in a matter of a few years. However, the recent experience in Europe's transition countries has shown that political willpower at the top level, supported by external forces, can enable countries to leap-frog a long way along the road in a generation if all pull together. Freedom of expression through the press or otherwise is an important tool in establishing this branch of government as an effective independent weight.

A competent judiciary promotes an understanding in a society that an individual will be treated fairly and will not be punished as long as he/she complies with the law. An adequately funded, fair and independent judicial system is required to ensure that the economy functions at a micro level and that contracts are efficiently and effectively enforced.

At a micro level, a reliable judicial system is important for credit analysis. The risk position of a creditor is favoured in relation to that of an equity investor because of its contractual claim for repayment by the company. However, with no effective judicial enforcement, the arrangement shifts to becoming reliant on the propensity of a company's management to repay what is due. The creditor is thus in a weaker position from a potential recovery perspective, particularly when the company's management is implementing the requests of dominant shareholders that may not be in the company's best interests. See Fitch's criteria report "*Country-Specific Treatment of Recovery Ratings*", December 2005 at www.fitchratings.com for further insight into this subject.

Banking System Framework

The level of oversight of risk management by a bank regulator is highly influential in the effectiveness of a bank's governance structure. This is because risk management and CG go hand-in-hand in a bank. Both look for an appropriate segregation of duties between those carrying out and those controlling the business. The best risk management and CG practices both require strong internal control systems. The implementation of Basel II

frameworks in banking systems throughout the world has been a strong driving force behind development of improved risk management systems, control environments and disclosure. The signs are that this is resulting in better implementation of CG in substance in the banks.

Fitch publishes separate reports on the banking systems and prudential regulations for banks it rates in the various countries around the world. These are available from the agency's subscription website www.fitchresearch.com. Understanding of these is a vital preliminary step in the rating process of a bank.

Bank regulators in any country work alongside securities regulators in establishing best CG practice. While stronger bank regulation is resulting in better CG in many emerging market banks, CG at the companies they lend to is generally not moving forward as quickly. An adequately funded and independent securities exchange commission with enforceable delisting powers can help to ensure good governance in the countries largest privately-owned companies. In many emerging market countries, however, the securities exchanges may be in a relatively weak position, particularly when the largest companies are either state-owned or owned by a small group of wealthy individuals. In these circumstances, the bank regulator becomes all the more important in developing best CG practices in the banks.

Efforts to strengthen CG throughout banking systems in a number of emerging markets have gained momentum over the past two to three years as a result of the following: recent experience of weak CG in banks resulting in systemic problems or even collapse; increased influence from banks in developed markets; pressure from various external sources, including the European Commission, SOX and foreign investors.

Analysis of emerging markets highlights the high correlation between the major or partial collapses of a number of banking systems and the weak CG of the banks in the systems at the time. It has, therefore, become an important issue for banking regulators in many countries to lead a drive for better CG practice.

Fitch has seen CG reforms in a number of banking systems, as discussed in Part II of the report. However, it is difficult at this stage to gauge the robustness of these reforms, given the relatively benign operating environment. How far-reaching the reforms prove in practice will be tested properly only once the next signs of economic difficulties emerge: will banking systems collapse again or will governance initiatives become entrenched in the systems so that a crisis is avoided?

Governance in the Banks

As public pressure in emerging markets brings about more liberalised economies and more representative governments, and consequently a demand for better CG, codes of good CG have been increasingly introduced, either collectively country-wide or on an individual firm basis. Such codes, however, are of limited value without effective implementation procedures – and indeed, the implementation of such codes in many of the emerging markets that have adopted them, remains woefully inadequate.

In developed economies, it is common to have voluntary CG codes in conjunction with mandatory disclosure about a company’s compliance with such codes – the so-called “comply-or-explain” principle. This promotes managerial transparency, which is necessary for accountability, while at the same time allowing maximum leeway for managerial discretion and flexibility, which can be important in fast changing and rapidly developing industries. Monitoring of the requirement for and companies’ adherence to CG codes is largely down to stakeholders – i.e. those with a particular interest in the firm (customers and providers of equity and debt funding, employees). Implementation is largely achieved by the influence of these parties on the banks and management rather than relying on regulatory bodies and judicial systems.

Without a strong and established economic framework of activism from the various stakeholders, any CG codes are likely to favour one type of stakeholder (e.g. a family or government interest) above the others. Legally enforced CG requirements could mitigate this to some extent. However, unfortunately so far CG codes in most emerging markets remain voluntary. As they often stem from securities rather than specific bank regulators, they tend to be restricted to listed banks, thus excluding large chunks of the various banking systems.

Ownership

For banks in emerging markets, Fitch has identified the single most common driver of the strength of CG to be ownership. Opaque, conflicted or volatile ownership structures can hinder establishing effective CG, as they result in weaknesses in the agent (management) and principal (shareholder) relationship. Management should be appointed and monitored and should operate independently from the owners yet still be accountable to them. The aim is to achieve the following:

- To facilitate and stimulate the performance of corporations by creating and maintaining incentives that motivate corporate insiders to maximise firms' operational efficiency, return on assets and long-term growth;
- To limit insiders' abuse of power of corporate resources – whether such abuse takes the form of insiders asset stripping or otherwise siphoning off corporate resources for their private use, and/or their causing significant wastage of corporate-controlled resources – which are otherwise likely to result from any insiders' self-serving behaviour;
- To provide cost-effective protection of investors' and society's interests vis-à-vis corporate insiders.

Given that capital markets are still in development in most emerging market countries, local ownership often takes the form of either state-ownership or control by one of the country's select group of wealthy families. This generally remains true even after the companies are listed. Once an economy starts to prosper, its market place becomes more competitive, and companies looking to sources of capital from the debt and equity markets (both domestically and internationally). A need to establish the agent/principal relationship evolves from this, as new investors demand more accountability and transparency, and better CG in general.

Banks have also turned to the capital markets for resources when governments' fiscal constraints have resulted in a decline in the role of development banks and other government investment arms.

State Ownership

Large scale privatisations in many countries have reduced the importance of state-owned banks in emerging markets. However, where the state has remained a majority or full owner, certain aspects of CG have remained of concern. In particular:

- In emerging markets in particular loans to the government and government bonds tend to represent substantial proportions of banks' assets. Also, minimum liquidity reserve requirements may require banks to place high volumes of deposits with central banks. If the state and/or its central banks are also the owners of the bank, conflicts of interest can be rife.
- Boards are unlikely to be independent, and even the appointment of management and decisions on how these people are paid may be based

more on whom the government wants to favour than on who will be best for the bank. This means that issues such as unrestricted related party lending, fraud and corruption are likely to be more prevalent.

- Product and business development decisions will favour whatever is to the government's short-term advantage, which may not be in the best interest of the bank and other stakeholders, such as creditors. Although government owned and controlled banks will often have low Individual ratings because of the effect of this not only on CG but also on stand-alone financial performance, the support that a state would provide should a bank it owns fail will generally mean that the bank's Issuer Default Rating ("IDR") is close to, if not at, the level of the state's.

Banks Owned by a Group of Private Individuals or a Family

CG concerns that arise from this form of ownership structure are mainly with regard to related party lending and lack of transparency particularly if the board is dominated by the largest shareholder. Fitch is particularly concerned about potential conflicts of interest controlling private shareholders may have when they also own substantial stakes in other companies. (See comments on "Related Parties" below.) In contrast, private shareholders that have all their assets concentrated in one bank may turn out to be a positive influence on the way the bank is run. Complex holding structures have proven to be problematic because often they hide the identity, or the size of shareholdings, of ultimate beneficial owners. The Commonwealth of Independent States "CIS", Baltic States and Bulgaria are typical examples where complex holding structures have reflected weak CG. In Russia this has been encouraged by a combination of arcane competition legislation that complicates the consolidation of stakes in banks and the perceived greater political risk of shareholder disclosure. Owners of some of the banks in these countries also own several other types of businesses, and the lack of transparent public disclosure makes it difficult to understand who owns shares in what. Local regulators are trying to improve transparency by limiting cross-shareholding between banks and corporations. However, the ultimate shareholders are often difficult to ascertain and extended related party transactions are therefore difficult to quantify, as is true board independence.

Banks Controlled by Foreign Banks

Where emerging market banks have been acquired by banks with developed CG standards, this has generally been a positive development. Foreign shareholders have generally imposed their own CG standards and models on

their emerging market subsidiaries. (For example, the emerging market subsidiary of a western European bank listed on the New York Stock Exchange will have to comply with SOX, as well as the CG practices all ready adopted by the parent.) On the other hand, there have been instances where a majority stake is held by foreign shareholders with other shares publicly traded, and minority shareholders not treated as fairly as one might expect.

Listed Banks with a Wide Ranging Shareholding Base

These tend to have the highest relative standard of CG, particularly if they have full listings abroad that force the banks to adhere to the CG practices and disclosures required for those markets. It has become increasingly common for international portfolio investors to purchase shares and bonds listed only in the domestic markets, and these investors have become a force in themselves, demanding greater disclosure and transparency, and pushing the banks to adopt CG practices closer to those expected in international markets. International listings are increasing from some emerging markets as the countries' economies develop and the global marketplace grows smaller. Brazil, India and Kazakhstan have banks listed on the New York and London Stock Exchanges. A number of the large and medium-sized Chinese banks have been listing on the Hong Kong Stock Exchange, which is improving disclosure and should contribute to better CG over time.

Some locally quoted banks are also showing good improvement in CG standards. For example, in 2003 listed banks in Turkey (which hold over half of the system's assets) were required to abide by a new CG code issued by the Capital Markets Board of Turkey.

The Difficulty of Establishing Independent Boards

Even where laws and regulations exist, in practice, in a number of emerging markets, boards contain few, if any, truly independent directors. When banks are held by controlling shareholders, these tend to dominate and control the boards, whether the controlling shareholder is a family or individuals (as is often the case in Russia and CIS); foreign banks (as often occurs in Brazil, Chile and most of CEE); or the state (such as in India), where the board including the executive chairman and the "independent" directors continue to be "nominated" by the government. In the latter case, power is concentrated with the executive chairman, who is generally appointed on account of seniority.

In a number of countries, boards may exist because they are a legal requirement but often may be just a formality, which the shareholders bypass in their contacts with management. Furthermore, the quality of members may be limited by a smaller pool of experienced candidates than is generally available in developed markets. This is the situation in a number of domestically owned banks in the Baltics, where the average age (and experience) of board members is substantially lower than seen in western Europe.

In other countries, the rules and regulations are vague in respect of the definition of independence. In Chile, for example, additional regulations effectively impose a minimum of two independent directors but the law only refers to "international standards" governing the topic. In South Africa, most non-executive directors on the major banks' boards tend, for example, to be directors of companies that are major customers of the banks themselves and therefore not truly independent. Both Chile and South Africa have relatively advanced capital market structures in comparison with other emerging markets, and the weaknesses identified also occur in developed markets. However, the limited supply of experienced professionals who could be independent directors means that these weaknesses are likely to be more prevalent than in larger, developed markets.

Related-Party Transactions

The area of poor governance that comes up most prevalently and frequently for banks in emerging markets is related party transactions. This generally stems from family ownership of banks combined with substantial other business or personal interests – providing the owners with the opportunity to misuse bank resources for the benefit of its other interests (partially at the cost of its own investment in the bank, but also, and possibly more so, at the expense of the bank's other providers of capital and resources, most notably its depositors and other creditors).

Asia's financial crisis in 1997 (and subsequent crises in Russia and Brazil) drew attention to the problems of "crony capitalism" – i.e. the "relationship-based" rather than contract or "rules-based" systems of governance in many emerging markets.

Related party transactions are a governance concern if their underlying purpose is to benefit the related party at the expense of the bank's interests.

Fitch's main observations regarding related party transactions in emerging markets are as follows:

- It is difficult to define a "related party" narrowly enough to capture somebody who might have interests beyond the well-being of the company. While this is true in developed countries as well, the concentration of economic interests in a relatively narrow group of people in the country can make it more of an issue for emerging markets, particularly the smaller countries.
- There is clearly a lack of regulation controlling related party transactions in a number of countries. In others, regulations are in place but the limits are set so high that the problem is not resolved.
- In some cases, although limits exist, they do not apply to all shareholders. For example, they may exclude the government, as is the case in the United Arab Emirates ("UAE"), which is a problem given that government lending features highly in the system.
- Often actual related party lending is not fully transparent as is the case in the Gulf States and in some countries in CEE. Reporting of related party transactions may be complicated by an extended string of family connections, as is common in the Gulf States, or may be understated and distorted by complex legal structures, common in the CIS and some other CEE countries, which make it difficult to understand who the real owners are. The process can be made more difficult when the preservation of secrecy is engrained in the culture.
- A few emerging market countries do have strong regulatory and disclosure limits; constraints are conservative and related party lending is not deemed to be problematic. In Brazil, related party lending is officially prohibited, which should restrict the degree to which it is carried out in practice, although it would be impossible to legislate for full prevention of effective related party lending. In Kazakhstan, a strong regulator has been generally effective in limiting related party business, although concerns still exist about ownership transparency, and hence possible hidden affiliated party business, at some banks. Related party lending is also now more strictly regulated in Turkey than it was in the past, with limits on the amounts than can be lent. Some of the Gulf banks have good regulations in terms of lending limits and required disclosure, but the impact of these in real terms is restricted by the influence of the ruling families that is prevalent throughout the economy. Bank regulators in a number of emerging markets have set limits on the amount a bank may lend to related parties, although the percentages vary. In some countries related party transactions require board approval, while in

others banks are only required to disclose information. Details by country are provided in Table 1 at the end of this report.

- The level of related party transactions is decreasing in countries where access of companies to capital markets is improving, as affiliated companies are able to borrow more cheaply elsewhere. More transparency of the market and the company in question also encourages foreign investment, again relieving the related party finance burden from the "inhouse" banks.

Financial Reporting and Audit

In most countries, disclosure has improved markedly, even beyond recognition, in the past decade among banks in emerging markets. However, the end results still vary enormously. The adoption of International Financial Reporting Standards ("IFRS") at least for listed banks in some countries or the publication of IFRS financial statements on a voluntary basis by other banks has helped, although local interpretation of these means that they may still be some way from accepted international norms. Banks that are subject to US SEC guidelines also must file US GAAP reports at least annually.

Checks and balances on the integrity of reported financial data are provided by internal and external audit functions. The quality of each of these varies. The main difficulty in most emerging markets is a lack of trained accountants for both preparing and auditing financial statements. The "Big 4" accounting companies are present in most (but not all) markets, although only one or two may have the expertise to audit banks in some countries. The quality of the audit (external as well as internal) depends on the quality of staff on the ground. Even the Big 4 face the challenge of either training local staff adequately and retaining them or seconding expatriates, who will not necessarily speak the language the documents they are supposed to be auditing are written in, and, at least at first, are unlikely to have much of an understanding of the loopholes in the local market. In many emerging markets, and notably in Asia, the presence of the Big 4 audit firms is limited to affiliation with local firms, and international influence can be quite limited. It is often the case that one firm audits almost all of the banks in a country – particularly in smaller countries. The separation of the auditing and advisory functions of a bank's external auditors can be an issue.

Central banks often perform their own audits of a bank's controls – or commission an audit firm to do this for them. Those emerging market banks that are US SEC-listed are now subject to SOX 404 financial control reviews.

4. Regional Analysis

Fitch rates banks in numerous emerging markets. Its coverage can be segmented broadly into the following regions: Asia, CEE, Latin America and the Middle East and Africa. A summary of governance in each of these regions is given below. However, given the wide geographical spread and the range of laws and recommendations in force across emerging market regions, as well as the quality and application of CG among the financial institutions within each country, Fitch has limited its specific focus to the larger countries in the regions or those where such an analysis is most meaningful. As many of the banks Fitch rates in emerging markets are likely to be (and often have been) supported by their respective states or institutional owners, Long-term ratings are not necessarily the best indication of how Fitch views the banks on a stand-alone basis. The Individual ratings factor in CG concerns, although the impact of these on the ratings is often difficult to distinguish from other weaknesses contributing to a low Individual rating, such as poor asset quality, weak profitability or inadequate capitalisation.

Asia

While corporate governance standards within Asia's banking systems are as varied as the region itself, in the majority of countries where standards have historically been weak, we have seen a general improvement. The region's hugely expensive financial crisis of 1997/98, which was in part brought on and compounded by weak CG, was an incentive for improvement, and not just in those countries most directly affected. Another spur was a shift away from family and state ownership of the banks towards more diversified and more foreign ownership, which in turn largely arose out of the banks' financial-crisis induced recapitalisation requirements. Also, there has been a general desire on the part of some governments for more modern, stable banking systems combined with the realisation that this requires better CG. Asia's banks have been increasingly integrating with the international financial markets, raising both debt and equity, and this has brought pressure to bear for better, more internationally comparable standards of corporate governance. Such improvements, however, have generally come off a low base, and considerable further development is required.

China

The main banks within China's financial system are the "Big Four" state-owned banks (54% of system-wide assets), the three state-owned "policy" banks (8%), 11 "nationwide" banks (5%) and 170 "city" banks (6%, with only a few being of any notable size). The Big Four and policy banks are controlled by the central government, while the nationwide and city banks are almost all controlled (and indeed mostly majority owned – noting that ownership details are not transparent) by provincial and city governments respectively. There are very few truly privately owned and controlled banks in China. However, three of the state-owned banks are in the process of selling minority stakes to strategic international investors and the international public through listings in Hong Kong. One has completed this process, while the other two have secured strategic investors, and the market expects them to list over 2006/07. Of the nationwide banks, five are listed (one in Hong Kong) and of the city banks two are domestically listed. All the banks listed nationwide and city banks have secured minority stake, foreign strategic investors, as have numerous of those that are not listed.

Historically, almost all Chinese banks' lending operations were substantially directed by the governments that respectively owned/controlled them. Often loans were granted simply to support cash-flow negative state-owned enterprises, or to white elephant infrastructure and property projects at the whim of senior bureaucrats at central, provincial or city government level. Unsurprisingly, massive non-performing loans arose, which the central government subsequently had to cover, largely by recapitalisation. Meanwhile, competition was stifled, rendering the banks hugely inefficient, and lacking in innovation, product development, technological investment, staff skill development, risk management and control. Combined with weak regulation, there have been many cases of corruption and fraud. Fitch understands that the bribing of senior and middle-ranking bank officials to obtain credit was widespread and is likely to still be occurring.

Many banks have embarked upon reforms to render themselves more commercial. Most notable among these banks are three of the Big Four state-owned banks (i.e. those being listed) as well as numerous nationwide and city banks (again, mainly those that are listed and/or which are seeking foreign strategic investors). For many of these banks, the degree of overt government interference in their lending operations has been substantially reduced. This watershed in the way banking is done in China (including the listings and the allowance for foreign-bank involvement) was prompted by the central government (through the regulators) in recognition that the country needs

a healthy banking system for a healthy economy. Concurrently, the supervision and regulation of the banks has been significantly improved. This began with the separation of the regulatory function from the central bank in 2003, since which time the regulator's competence and resources have been enhanced, as have the regulations themselves. Both the banks and the authorities are taking a harder line against corrupt practices. All this has created a general improvement in CG (particularly among those banks that are listed and/or have foreign strategic investors). Operationally, the banks have developed significantly (particularly in regard to risk management and control), and there are much better accounting and disclosure standards. Furthermore, a number of banks have introduced outside and independent directors (often foreigners representing a foreign strategic shareholder as in the case of the three reforming state-owned banks).

Despite the significant progress achieved, however, there is a long way to go before CG among China's banks begins to approach that of the more developed world. Government interference is far from being eliminated; corruption, fraud and bribery continues; accounting and disclosure standards are still weak; a commercial culture is still at an early development stage; risk management and control remains basic; and the supervisory and regulatory framework still show some key deficiencies.

Improvements should continue through foreign bank input and nascent moves towards more banks being truly privatised. However, much will depend on whether government interference really diminishes and whether moves in this direction can be sustained in an economic downturn. Weak CG, particularly concerns about potential corruption and unreliability of financial statements, are holding back the banks' Individual ratings, which are all at the bottom end of the range ('D', 'D/E'. 'E').

India

CG among Indian banks is discussed across three broad categories – the state-owned banks, the "new" private sector banks (i.e. those that were given a banking licence in 1993), and the "old" private sector banks. At the risk of over simplifying, Fitch has drawn conclusions regarding banks in each of these groups, although standards of individual banks might be better or lower than the "median" governance practices discussed.

There are 27 state-owned banks in India, accounting for 75% of banking-system assets. Government ownership varies from 51%–100%. The state-owned banks

are governed by the Banking (Acquisition and Transfer of Undertakings) Act, which gives sweeping powers to the government. These banks have begun to list their equity on the domestic bourses, and have needed to comply with disclosure and good CG guidelines stipulated by the stock exchanges, which focus on the rights of minority shareholders. It is worth mentioning that boards, including executive chairmen and "independent" directors, are still determined by the government; and power is concentrated with the executive chairman, who is generally appointed on account of seniority.

The signs are that intervention by the state in state-owned banks' credit operations is declining. Direct intervention in decisions is being replaced by "policy directed" lending aimed at achieving the broader social objectives of the government in power. Increasingly decisions are based on commercial considerations, partly stemming from the bank's public listings and partly because of more investment in technology that brings greater transparency and is helping to standardise decision making. Foreign ownership of some shares in some banks and frequent interaction with large institutional investors has maintained pressure on these banks to adopt more progressive CG standards. Summing up, although there has been an improvement in the governance practices of these banks, the ownership overhang still remains, and they still comply more with the letter of governance practices than the spirit.

In India, CG standards are the highest among new private sector banks. Two of these, HDFC Bank (rated on Fitch's national scale for India at 'AAA(ind)', with an Individual rating of 'C') and ICICI Bank (IDR 'BB+' on Fitch's international scale and also with an Individual rating of 'C'), are listed on the New York Stock Exchange, and UTI Bank (rated 'AA+(ind)' and 'C/D') is listed on the London Stock Exchange. These banks adhere to the governance practices and disclosures expected by international investors. The boards of these banks are reasonably broad based, with independent directors of wide-ranging experience. Anecdotally the various board committees (compliance, audit, risk, compensation) are vocal, particularly in the internationally listed banks. All this has had a knock-on effect on the other domestic banks.

In sharp contrast, the old private sector banks have the weakest level of governance. These banks are controlled by a few families or by communities, with non-bank interests. While these banks might have outside directors and various board committees, these tend to be passive with real decision-making concentrated with the large shareholders – increasing the chance of related party lending.

The Reserve Bank ("RBI"), India's central bank, is focused on governance issues both from the perspective of improving the quality of its oversight and from securing the interests of depositors through transparency, off-site surveillance and prompt corrective action. The RBI has established two major committees to look into governance at the banks and benchmark international best practices of implementation. These committees have made recommendations directed at the independence and autonomy of the board and focused on harmonising the OECD/Basel/SOX recommendations with local regulations and practices followed in the domestic Indian market.

The Individual ratings of banks in India generally correspond to Fitch's views on CG, although they incorporate all of the other factors that influence a bank's financial position as well. New private sector banks typically have relatively high Individual ratings for the region ('C'), and those of the old private sector banks are at the lowest end of the scale ('D/E', 'E'). For the state owned banks, Individual ratings are typically between the two at 'C/D', 'D'.

One feature about financial reporting in the Indian banking system worth mentioning is that some of the large state-owned banks have a number of different auditors. This is a concern, given what Fitch has seen in the international market place – i.e. reliance on staff from other audit firms to complete an audit for large international groups has resulted in errors going unnoticed. This is a resource issue in the audit firms, given the scale of the large state-owned banks' operations. For example, State Bank of India (rated 'BB+' and 'C') has 9,000 branches, Punjab National Bank (rated 'AAA(ind) and 'C/D') has 5000+, and Bank of Maharashtra, although smaller, still has over 1,000 branches. In addition to the geographical spread, the regulatory requirement for results to be audited within three months of the year end also means that several firms have to be hired to ensure that the audits are completed. Typically, these audit firms form a "central committee" that looks at the audit reports that come in from the branches and the regions and then discusses these jointly with the chief financial officer of the bank. As these banks appoint auditors for only a three-year period, it has not been feasible for one audit firm to build the necessary infrastructure in terms of people and offices to audit these banks on its own.

Indonesia

There has been a dramatic improvement in CG among Indonesia's banks since the 1997/98 Asian crisis, which rendered most of them insolvent.

Before the crisis, CG among the banks had been very poor. Indeed a major factor in the bank failures was related party lending; among the private banks (which accounted for around 50% of system assets and which were predominantly owned by families and/or conglomerates with substantial non-bank interests), related party loans often accounted for 30% to 70% of their total loans. Meanwhile, the state-owned banks (40% of system assets) granted many of their loans purely on the basis of political connections to, as well as under the direction of, the ruling Suharto regime. All this was done with the acquiescence of the regulator, the auditors (notwithstanding international affiliations), nominally independent directors and others.

Notably, among Indonesia's mid-sized banks, there were some family-owned banks that not only comfortably survived the crisis but prospered during it by being recipients of flight-to-quality funds. This was largely because these families did not have extensive non-bank interests and/or in some cases because there were numerous families with a stake in the bank providing natural checks and balances against abuse by any one family or group of families.

Numerous failed banks were bailed out by the state and consequently nationalised before being sold back to the private sector. There was initial concern that such sales would return the banks to their former, or perhaps new, corrupt family/conglomerate-based, owners, and there were some questionable sales. However, given close public scrutiny of the process (aided by greater press freedom) combined with the public's new-found electoral powers, in the main the process was reasonably transparent. This resulted in most banks being majority-sold to reputable foreign institutions, including Standard Chartered Bank, UK (IDR: 'A+'), Kookmin Bank, Korea ('A'), Bumiputra-Commerce Holdings, Malaysia, as well as the investment arms of the Singaporean and Malaysian governments. In line with standards expected in their home countries, these new owners have introduced much greater levels of transparency and disclosure, a greater role for truly independent directors, and much more rigorous standards of CG in general.

Notably, the improved level of CG among Indonesia's banks has in part been facilitated by the collapse of many large, self-interested conglomerates during the crisis. Finally, there has been a marked improvement in the competency and integrity of the regulator (which rightly bore a lot of the blame for the crisis).

There have been widespread staff changes, an upgrading of staff skills and the introduction of much stricter prudential standards for the banks with more rigorous monitoring and implementation. The regulator is in the process of

drafting a code of good CG for the banks. The state-owned banks have also seen significant improvements, through the replacement of management, the sale of minority stakes to the public and institutional investors, and with the government no longer directing loan decisions (now much more difficult given the presence of more vocal political opposition parties). The example set by the newly foreign-owned banks also appears to be spurring on the state-owned banks towards better CG. Not all has run smoothly, however. There have been some high-profile cases of fraud and corruption involving mid-to-senior level officers at the state-owned banks. Such cases were uncovered and generally harshly dealt with, which was a welcome change for the system. The commercial orientation of the state-owned banks' management and staff continues to lag that of the private banks, and it remains to be seen whether the banks will again become subject to government interference, particularly in the event of any serious economic downturn.

In summary, CG among Indonesia's banks is considered mostly satisfactory, and likely to continue improving under its new (although young and potentially still fragile) democratic system of governance, as well as its more diversely owned corporate sector. Nevertheless, downside risk remains, with governance at the broader corporate level substantially less developed, with significant levels of corruption among businesses, the bureaucracy and politicians persisting. Furthermore, the judicial system remains endemically corrupt, rendering contract enforcement unpredictable and expensive.

CG along with much improved balance sheet strength, due to recapitalisation by government and strong profitability, has contributed to a general improvement in Individual ratings of Indonesian banks over the past two years. However, environmental factors, such as potential economic volatility and an ineffective legal system mean that the ratings are still lower than average (mostly 'C/D').

The Philippines

Unlike Indonesia et al, the Philippines, initially at least, was not very hard hit by the Asian crisis[4]. Consequently, there was less pressure for much-needed reform of the banking system, and little reform occurred. For a while, governance development seemed to go backwards. The system is dominated

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[4] This was mainly because short-term debt and equity investment by foreigners into the Philippines was relatively small before the crisis. Hence capital flight was more limited, resulting in lower currency devaluation and limiting the need to raise interest rates.

by some 12 local banks (77% of system-wide assets) and a few foreign banks (16%). Of the 12 local banks, two are government-owned policy banks. The others are mostly listed but are all controlled by local families/conglomerates, all of which have substantial non-bank interests. Competition is constrained, with limitations on foreign bank involvement and expansion resulting in cartel-like behaviour by the local banks – so while revenues are good, efficiency is poor, as is technological investment and product development.

Meanwhile, related party lending is high, the use of truly independent directors limited, accounting and disclosure very weak, and supervision/regulation constrained and even abrogated by the power of the vested interests, which own the banks over elements of the political and judicial systems.

There have been some positive developments. Most notably, the regulator has tightened a raft of prudential regulations and requirements, and IFRS have been adopted. Nevertheless, to what extent the regulator can enforce its rules remains to be seen. Forbearance by a regulator powerless to enforce the rules has been a feature of the system for many years. Likewise, to what extent accounting integrity and disclosure will improve under IFRS remains to be seen. Again this is an implementation issue. Accounting in the Philippines has been very poor, and Fitch remains concerned that the audit of banks continues to be dominated by just one local accounting firm. Ultimately, it would seem that for there to be a true change in the CG practices of the Philippine banks, more diversified bank ownership will be required.

With the Individual ratings of the larger banks generally at 'D/E' and others at 'D', the Philippine banks are at the low end of the scale. Although these ratings incorporate CG, the very weak balance sheets and underlying profitability of the larger banks would need to improve as well as CG before an upgrade were to become achievable. The 'D' banks' ratings are held down by exposure to interest rate risk in a domestic environment that could be susceptible to hikes. Better CG could result in improved financial performance and would almost certainly be positive for risk management, so may be the key to moving the ratings. However, there is little sign of this happening in the foreseeable future.

Thailand

While Thailand's banks were mostly family controlled prior to the 1997/98 Asian crisis, they generally did not have substantial other interests. Therefore,

related party lending was not as problematic as in numerous other Asian countries (although Fitch did see some related party problems in a few smaller banks owned by families with significant other interests); nor was there much in the way of major incidences of fraud and corruption among the banks. This can be largely attributed to the historically generally good level of supervision and regulation imposed upon the banks, not just by the central bank (the Bank of Thailand, "BoT") but also by the Securities Exchange Commission ("SEC").

With the controlling shareholders unable to meet fully the recapitalisation requirements of their banks after the Asian crisis, the banks had to seek third party funding, resulting in the ownership of Thailand's banks becoming more diversified. Whether this leads to greater CG and management professionalism among the banks over time remains to be seen; the families are often still involved in the banks' management (mostly quite competently), and shareholder activism in Thailand is not strong. Two small local banks have been wholly acquired by foreign banks (namely Standard Chartered Bank and United Overseas Bank, Singapore, rated 'AA–'). However, foreign presence remains limited and Fitch does not expect it to have any major influence on CG standards in the country in the foreseeable future. Spurred on by the problems that were experienced during the Asian crisis, as well as by the better standards of corporate governance being introduced across the region and more broadly, the BoT and SEC have continued to impose more stringent requirements on the banks, as outlined in the table attached at the end of this report. The BoT has also worked towards improving its supervision of the banks, focusing more on their consolidated operations and with a greater bias towards an early detection of problems, enabling it to require the banks to take preventative measures.

While the state has stakes in numerous Thai banks, these are mostly minority stakes, and the banks concerned are managed on a commercial basis with the state exercising little influence. Even Krung Thai Bank (IDR rating 'BBB+' and Individual rating 'C/D'), which is Thailand's largest bank with 18% of system-wide assets and has historically been majority owned by the state (53%), is managed mostly on a commercial basis. The Individual rating was raised to 'C/D' from 'D' in July 2006, partly because of lower loan impairment charges. Fitch saw a risk that the high loan growth over 2003 and 2004 had potentially been based more on supporting Thailand's economic growth than on purely commercial considerations.

CEE

Economic and regulatory development in CEE can be broadly split into two camps: the more western European transition economies that have either recently joined or are on track to join the EU, and the eastern European countries that form the CIS.

CIS

In the CIS, CG concerns are often a significant negative factor in determining rating levels, particularly for the smaller private banks. Some improvement has been seen, however. CG codes issued by the securities authorities have limited impact without a process of implementing them, and not all banks are listed. The banking regulators' role is, therefore, key in influencing CG in many of the banks Fitch rates in these markets. Only one CIS bank (Kazakhstan's Kazkommertsbank ("KKB", IDR 'BB+', Individual rating 'C/D') has an international listing and the equity of only one (Sberbank – Savings Bank of the Russian Federation ('Sberbank'), rated 'BBB+'; 'C/D') is actively traded. However, the largest Russian, Kazakhstani and Ukrainian banks (in total more than 30 institutions) have made international debt issues during the past three years, which have required improved standards of disclosure.

In Russia and other CIS countries, particularly where the ownership structure of banks includes large stakes by single families/individuals, boards are often just a formality, existing because it is a legal requirement, which the shareholders often bypass in their contacts with management. Effective board oversight or board committees are rare in the region, but the situation has improved at some of the largest privately-owned Kazakhstani and Russian banks. Board members are often drawn from the management or directors of affiliated corporates and may have little experience in the banking sector.

Related party lending remains very prevalent at smaller Russian and Ukrainian banks. However, business with affiliated entities seems less significant in Kazakhstan, and significant improvement has been seen at the largest privately owned Russian banks. This is partly due to the ability of an increasing number of corporates (owned by the same shareholders as the banks) to access finance from international banks/capital markets and/or stateowned banks more cheaply and in greater volumes. This reflects the corporates' superior credit quality and the regulatory capital constraints of the banks. It also reflects shareholders' increasing focus on banks as

value-creating institutions, and attempts to strengthen franchises and clean up balance sheets prior to possible IPOs or sales to strategic investors. Similar trends at leading Ukrainian banks are now being strengthened by the sale of many of these institutions to foreign banks.

Kazakhstan

Most major banks are listed in Kazakhstan but the share in ownership of foreign and domestic institutional investors is low, and control remains in the hands of a few individuals/families. Transparency about shareholders varies. KKB provides full public disclosure on ultimate beneficial shareholders, but uncertainty remains as regards the stakes held by owners of some other banks. Boards are in many cases form rather than effective bodies, although the input of the EBRD's representative into KKB's board is substantive, and board-level oversight appears to have strengthened at Bank TuranAlem (rated 'BB+'; 'C/D'), the second-largest bank. Improvements in corporate governance at these banks are positive factors for their 'C/D' Individual ratings, although the ratings are driven primarily by the banks' financial profiles. Related party lending is reported to be low, and generally it probably is so, although sometimes opaque ownership structures may conceal some affiliated business. The largest banks regularly tap international debt markets, ensuring regular financial and business disclosure.

Russia

At most of the larger privately owned Russian banks, however, there have been substantial improvements in business models (a marked reduction in related party business and speculative investment/trading), transparency and ethical standards since the 1998 crisis. At that time, weak or non-existent board oversight in Russia combined with a lack of adequate regulatory supervision and opaque group structures, had contributed to several highly publicised cases of bank failures. The failure of a number of smaller Russian banks in 2004 can also largely be put down to poor CG and bank regulation.

In both the failures of the large banks in 1998 and those of the small banks in 2004, common practices included banks or their shareholders acquiring stakes in corporations with depositors' money, lending to affiliated corporates with subsequent non-repayment of loans and stripping of assets, including those pledged as collateral, as defaults became imminent.

Since 2004, there has been greater regulatory focus from the Central Bank of Russia ("CBR") on CG issues such as ownership transparency, fictitious capital and related party lending. In August 2005 the CBR published a discussion document on CG practices, covering such issues as board composition and role, disclosure, risk management and conflicts of interest. Among other things, the paper proposes to limit a bank's total exposure to affiliated entities to 15% of equity. At present there is still a lack of regulation controlling related party transactions.

State directed lending does not appear to be prevalent at Russia's largest bank, Sberbank (majority state-owned but a significant minority is held by portfolio investors). Fitch has been informed there is no directed lending at the other major state-owned bank, JSC Vneshtorgbank ("VTB", almost 100% state-owned, rated 'BBB+'; 'C/D'), nor at Vnesheconombank (another state-owned institution, rated 'BBB+), although this is difficult for the agency to confirm, since it does not have access to the names of major credit exposures at these two banks.

The private banks tend to be very closely held, typically by one or two individuals, although this ownership is normally via nominal (shell) companies, resulting in problems of transparency and related party lending. Concurrently, ultimate beneficial ownership has been disclosed by all banks to the CBR as a condition of entry into the deposit insurance system. Ultimate beneficial ownership is now typically also included in leading banks' IFRS accounts. Furthermore, as noted above, affiliated business has decreased markedly at larger institutions.

CG is influencing the ratings of some Russian banks, generally holding them down. However, stronger CG, specifically the appointment of a majority of independents to the board and the creation of board level committees, was a factor in the upgrade of MDM Bank to 'BB–' from 'B+' in October 2005.

Ukraine

In Ukraine, the majority of the large banks were, until recently, controlled by a small number of individual shareholders, usually also owners of a large financial industrial group. The boards tended to be comprised primarily of representatives of the main shareholder(s), if not the shareholders themselves and were often bypassed by shareholders in their contacts with management. Board committees have been rare.

Fitch anticipates that significant changes to corporate governance will result from the ongoing acquisitions of the country's leading banks by foreign institutions. In 2H05 and 1H06, agreements were signed providing for the sales of majority stakes in three of the country's top five banks to Raiffeisen Zentralbank, Austria, BNP Paribas, France (rated 'AA'; 'B') and Intesa, Italy (rated 'A+'; 'B'). Foreign ownership should reduce related party lending and – where local shareholders retain minority stakes in banks – provide additional comfort that any remaining related party business is concluded on an arm's length basis. Evidence of improvement in CG will be one of the factors likely to result in an improvement in the banks' Individual ratings once the influence of the new foreign owners takes hold.

European Transition Countries

In the early 1990s ineffective privatisation of state-owned enterprises on a huge scale resulted in a number of schemes by the more entrepreneurial citizens of the new "free" world, leading to an unexpected concentration of control over companies and the banks themselves. The state remained very influential in most of the large banks in the region until the mid-1990s, and lending was largely state-directed rather than on commercial terms and to the old state industries rather than the retail market or new entrepreneurs. This, combined with a lack of experience by the authorities and poor capitalisation, resulted in many of the region's banks being renationalised and sold to foreign investors in the mid-late 1990s. Governments were faced with the need to recapitalise their banking systems at the same time as they were trying to get their macro-economic position up to speed for EU accession. CG has been pushed forward in the region by both the dominance of foreign investors in many of the transition countries' banking systems as well as a drive by those running the countries to have a financial infrastructure and regulation in place that met the requirements for EU accession. However, a legal framework can only go so far in embedding a strong CG culture, and much of the essence of good governance requires experience that is still a scarce resource in these markets – although it is developing fast and generally in the right direction.

Baltic States

The recent history of the EU's three small Baltic states, Estonia, Latvia and Lithuania is unusual in that the countries were all part of the Soviet Union until they regained independence from Russia in 1991. Since then their economic development has followed the line taken by the central European countries rather than the CIS. Estonia's banking system in concentrated

almost exclusively in two Swedish-owned banks and the majority of banking assets in the other two countries is also controlled by foreign shareholders. Foreign shareholders have had a positive influence on developing what are broadly robust CG practices in the banks they own in the Baltic states. However, the influence of more Russian-style practices of CG, particularly where related party transactions are involved, can still be seen in some of the banks in Latvia and Lithuania, and these CG weaknesses continue to be a negative rating driver. Reporting of related party transactions are sometimes distorted by complex legal structures. In Lithuania, company law requires disclosure of ownership exceeding a threshold of 10%. In practice, however, some shareholders hold 9.99% of votes or have informal relationships with each other that are not always disclosed, especially where the parties involved wish to conceal their arrangements.

Czech Republic

The voucher privatisation of banks and companies in the Czech Republic in 1991–1995 allowed a number of Privatisation Investment Funds ("PIFs") to become the most important owners of the country's prime businesses in the immediate post-privatisation period. Heavy inter-fund trading rearranged the PIFs' portfolios without any government intervention (there was no enforcement of legal provisions or regulations and no notification and disclosure requirements) and facilitated a wave of mergers and acquisitions that contributed to further concentration of ownership and/or control. This affected the largest Czech banks in two important ways, each of which resulted in a huge cost to the state.

Investicni a Postovni banka ("IPB") was the victim of opportunistic foreign investors benefiting from the "chaotic" ownership structures that were created in companies. A scandal at the time suggested that the investment in IPB by a subsidiary of Nomura Holdings Inc was driven more by a desire to raid its brewery investments than an interest in participating in the development of the Czech banking system. In any case, the bank failed and the regulators had to step in, hand control over to another bank and inject capital to compensate the losses that had been created by poor governance. IPB finished up with a web of investments that took years to unravel. The other way that banks were affected was by granting loans to the investors in PIFs, secured on the investments. When the PIFs failed to realise the profits that had been hoped for, investors failed to pay their loans and some of the large Czech banks ended up as the main investors in the PIFs. The PIFs in turn held some substantial stakes in the banks, a circular ownership structure that weakened the capitalisation of

the Czech banking system at the time substantially. The banking system had to be bailed out by the state, and the largest banks were subsequently sold to western European banks. The strength and commitment of the new owners and improved regulation mean that the conditions that led to the system's failure are no longer present. A repeat of this scenario is unlikely despite some weaknesses in transparency at the remaining private banks.

Foreign ownership has raised some issues for minority owners of subsidiaries of the acquired banks, whose interests have been subordinated to those of the new ultimate shareholders trying to consolidate their global operations. However, these issues are minor in comparison to the CG problems in the system 10 years ago. CG in the main Czech banks is now more or less in line with that at their western European parents.

Hungary

Hungary also experienced its share of CG failures in the 1990s, most notably at Postabank, which suffered catastrophic losses due to the aggressive expansion policy the state enabled the bank's inept and corrupt senior management to pursue. The large Hungarian state-owned banks were sold to foreign investors earlier than other banks in the region. What seemed like relatively cheap acquisitions at the time for the new owners, however, generally evolved into a lengthy, expensive restructuring process. Developing CG systems was at the heart of this, including heavy investment in IT and infrastructure, as well as sorting out mismanagement and legal wrangles, often involving state-directed lending to the large state-owned (or previously state-owned) Hungarian companies, that had resulted in poor asset quality.

The extent of the problems weak CG had caused often came to light for the new owners after they had acquired the company. Those that did not take a hands-on approach to dealing with this early on usually saw problems escalate. The foreign owners now seem to have the problems behind them and are involved in management and CG of their Hungarian subsidiaries. The loss made at Kereskedelmi es Hitelbank's (rated 'A'; 'D') equity broker in 2003 and the time taken to sort this out indicates why Fitch still has some concerns over the control environment and CG in the parent banks' subsidiaries.

Hungary has an unusual board structure. Companies have a board of directors and a supervisory board, which is not uncommon in central Europe. However, the board of directors includes both executive and non-executive members, and supervisory responsibilities are split between the two boards. Supervisory boards

in some cases are quite small. In Fitch's view, a complete separation of supervisory functions into a larger supervisory board would constitute better CG.

Orszagos Takarekpenztar es Kereskedelmi Bank (OTP Bank), the largest bank in Hungary and one of the larger banks in the region is a rare example of a listed transition company with almost full free float (the government retains a "golden share"), with the shareholder structure dominated by foreign portfolio investors. The dominant force in OTP is its CEO, and to date investors appear to have been satisfied with the strong equity performance of their investment without paying much attention to developing an accountable CG structure. However, the bank is now embarking on its own acquisitions in eastern Europe, and as it expands internationally and becomes increasingly complex, it is likely to face demands to strengthen CG and transparency.

Poland

The early years of Polish capitalism saw poor compliance with corporate governance standards. One prominent example was the case of Bank Staropolski. The bank placed deposits with banks in the Ukraine and Moldova, controlled by one of the owners, which failed, and as a result Staropolski became insolvent in early 2000. However, almost all the major banks in Poland are now majority owned by western banks. In general this has been positive for CG in the system, although the process has not been smooth. Between 1999 and 2004 CG rules were often bent by shareholder conflicts, aggressive investment tactics, unexpected breaches of trust by former allies, and the mistreatment of minority investors. Some of the biggest CG conflicts arose from inherent tensions between foreign investors looking to fit their Polish subsidiaries into a multinational network, and local investors seeking to maximize their short-term returns. As late as 2004, the case of BRE Bank SA (rated 'A–'; 'D'), which at the time was 50% held by the German bank Commerzbank ('A'), highlights the ineffectiveness of the supervisory and management boards at the time in controlling the ambitions of local management. The bank continued to invest in equity stakes in a company in receivership and did not exit or stop lending as a result of the strategic and political ambitions of the chairman at the time. The bank was forced later to write off its bad debts and had to be supported by its major shareholder.

Slovenia

Slovenia has seen less foreign investment in the banking system than other European transition countries, mainly because of government's protective

stance. Privatisation took place in the late 1990s by way of partial free distribution of shares to employees, state funds and the general public. The continuing presence of the state through privatisation funds allows it to continue to combine its function as a stockholder and as regulator, and to subordinate corporate decisions to political goals. Individuals and employees do not take much active involvement in corporate decision making allowing institutional investors (pension funds, banks, insurance companies, investment companies and state controlled funds) to pursue a very active role. Institutional investors intervene in day-to-day decisions and put pressure on decision making by the management boards. There is still a high degree of political interference in the running of Slovenian banks, which has to some extent limited the operational flexibility of the banks in terms of expansion, aggressive competition with each other and potentially staff lay-offs. Taking both this and the state's somewhat closed position to the possibility of wide foreign ownership into account, ratings of Slovenian banks can be said to have been influenced by the governance structure, although this has been in a more subtle way than in other developing markets. Four Slovenian banks have Individual ratings of 'C', with one at 'B' and one at 'C/D'. Three of the banks have IDRs at 'A–', with two at 'BBB' and one at 'BBB+'.

Latin America

The extent and quality of CG among financial institutions in Latin America is as varied as the region's countries and banks. The ownership of a significant number of banks is closely held, either by local interests or by foreign shareholders; even when banks are publicly traded, the float generally consists of minority shareholders, which often hold limited voting rights. CG practices among banks are generally driven by one of two related factors – whether the banks are listed on local stock markets and whether or not they are international issuers of debt and/or equity. Ownership by foreign banks is also an influencing factor. With some exceptions, the lead in regulations concerning CG is generally taken by the local stock market regulators, and this lead is often influenced by practices dictated by the US Securities and Exchange Commission ("SEC") and more recently, the SOX. Banking regulators' actions in this sphere have often followed those of stock market regulators, and/or been influenced by a significant presence of foreign shareholders in the systems they regulate. In this discussion, Fitch will focus on governance practices in three of the region's most important countries, Brazil, Chile, and Mexico. As one would expect, these markets are more integrated with international markets and practices, and therefore, governance practices are generally more advanced than in the smaller markets.

Brazil

CG in Brazil is driven principally by the Comissao de Valores Mobiliarios ("CVM"), the primary regulator for the local stock market, the BOVESPA. In addition, a number of the major banks must also comply with SEC and SOX guidelines, given their profile as active debt issuers in international markets and, in three cases, of ADRs on the New York Stock Exchange ("NYSE"). The IBGC (Brazilian Institute for CG), an independent association established in 1995, has also gained importance as a disseminator of CG best practices in the local market, and has published a CG code. This code is not, however, binding on publicly traded institutions. The banking system consists principally of closely held banks, although the bulk of the system's assets is held by two government-owned banks and a group of four dominant privately held banks, all but one of which are locally controlled. One of the state-owned banks and the private banks are publicly traded, although controlling blocks are closely held. The use of preferred non-voting shares is common, and these represent an important portion of publicly traded shares of financial institutions, making the treatment of non-voting stakeholders an important CG issue.

The CVM establishes guidelines for the composition of the board of directors, its broad functions, and sets guidelines for the minimum disclosure of financial information. Given that the bulk of the publicly traded companies would not comply with global best practices, BOVESPA has encouraged further development towards this end by establishing a more restrictive group of publicly traded entities which follow CG guidelines that are stricter than CVM minimums. Participants in this restricted group are still relatively few (less than 10% of the total of listed companies) but include the three leading privately held banks – Banco Bradesco (rated 'BB'; 'B/C'), Banco Itau (rated 'BB'; 'B/C') and Unibanco-Uniao de Bancos Brasileiros (rated 'BB'; 'C').

CVM guidelines establish that the board of directors should consist of a minimum of five and a maximum of nine members but state only that independents should constitute the "maximum possible" number of board members. The Central Bank requires that banks constitute an audit committee, which must contain at least two independent directors, and be chaired by an independent board member.

CVM guidelines also establish that the chairman of the board and the CEO should not be the same individual. In practice, most boards contain few if any truly independent directors, and most boards are dominated by the controlling

shareholder. Board structures are generally one tier, with the participation of a limited number of senior executives. The large banks have also generally constituted several board committees to deal with compensation, risk management, financial disclosure, among other things, but participation of independent directors on these committees is limited.

Minority shareholders' rights have gained greater recognition over time. Two of the three leading banks have instituted requirements to protect minority shareholders, and the CVM has established that preferred shares may not constitute more than 50% of total shares.

Disclosure has improved markedly in the last decade among banks and in the market in general. Banks must now publish financial information quarterly, and the bulk of the significant banks do so on a consolidated basis. Notes to financial statements usually add significant further disclosure, although the extent of this still can vary considerably, especially among unlisted entities. The banks that are subject to SEC guidelines also must file US GAAP reports at least annually, and the CVM requires that anything disclosed in filings for regulators outside of Brazil must be public information in Brazil. Related party transactions are restricted by both CVM and Central Bank guidelines, with the latter establishing an outright prohibition on lending to related parties, although these may place deposits.

The benefits of solid CG practices have been given more weight in the past three to five years, given the attention paid to governance-driven corporate traumas in the developed world. In addition, the failure of Banco Santos, a highly visible medium-sized bank, in late 2004 was due, at least in part, to poor governance practices, which helped conceal poor management and fraud over a prolonged period. The bank's failure put additional pressure on other market participants to continue the positive momentum of adopting solid governance practices. Typifying the diversity of practices for many things in Brazil, the quality of governance practices being followed by financial institutions varies from world-class to non-existent. The banks that have led the way are receiving increased attention both at home and abroad for their efforts, and this could lead to greater market access and the resulting benefits. It is hoped that solid CG practices evident at the top of the financial system will, over time, spread throughout the whole system. Good CG ranks alongside profitability and balance sheet integrity in the Individual ratings assigned to the best Brazilian banks, which are higher than the ratings assigned to most banks in emerging markets and are exceptional for banks operating in a country with a sovereign rating as low as 'BB'.

Chile

Minimum regulatory requirements for CG in Chile derive principally from the Ley de Sociedades Anonimas ("LSA"), which governs the formation of all corporate entities and sets out certain minimum governance requirements. Financial institutions must also abide by additional guidelines set by the Superintendencia de Bancos e Instituciones Financieras ("SBIF"), the bank regulator. In addition, the three largest private banks in the system (Banco Santander Chile (IDR: 'A'; Individual rating: 'B'), Banco de Chile ('A'; 'B/C'), and Banco de Credito E Inversiones (rated AA(chl) on the national scale for Chile) are listed on the NYSE, making them subject to SEC guidelines for disclosure and governance. None of the banks have their own CG code, although several publish codes of ethics.

The LSA dictates that a single board of directors must be created, with a minimum of five members and a maximum of 11; there are no specific requirements for independent directors. Additional regulations effectively impose a requirement for a minimum of two independent directors; the definition of independent director is vague, as the law refers only to "international standards" governing the topic. The LSA requires the creation of a directors' committee, which reports directly to the board and is composed of three directors, at least two of which should be independent. This committee is delegated the oversight of financial statements, related party transactions, proposal for and oversight of external auditors and rating agencies, and approval of compensation for executive management. The SBIF also requires the creation of an audit committee that must contain at least two independent directors, one of which will preside over the committee; it also recommends that the general manager and internal auditor should participate. The LSA also prohibits directors from being employees of the entities they govern, effectively limiting executive participation on the board.

The SBIF has placed increasing emphasis on self-regulation by the banks, placing the responsibility on the boards to show that these are aware of the formation and application of policies and procedures. As a result, the banks' boards have been given incentives to create operating/oversight committees, with active participation from board members and management, to oversee matters such as operational risk, portfolio management, and financial controls.

The banking system is largely privately held, as only the three largest private banks are listed, and these three float between 10% and 40% of their shares. In practice, boards are dominated by directors, which are appointed by the

controlling shareholders. The local pension funds ("AFPs") hold minority positions in the listed banks and have encouraged the appointment of independent, professional directors. Disclosure is adequate, and those banks listed on foreign exchanges must make public any filings required for these listings. Related party lending must be done on market terms and pass the scrutiny of the committee of directors. Regulatory limits are fairly generous, as individual exposures may be up to 5% if unsecured, and 25% if secured; total related party lending may not exceed a bank's capital. Actual outstanding related party lending across the financial system is about an eighth of system equity.

Financial disclosure is adequate, and those banks listed on foreign exchanges must make public any filings required for these listings.

Mexico

The Mexican banking system is dominated by banks with strong foreign shareholders, which together hold roughly 80% of the system's assets; another 12% of assets are controlled by the two largest locally held banks (family controlled), with the balance spread broadly among a wide number of generally closely held banks. Only a few financial holding companies are publicly traded, either in local or international markets. Consequently, the main impetus for establishing minimum CG requirements for all banks has come from the Comisión Nacional Bancaria y de Valores, the bank regulator. Most of the elements an industry-wide CG code are embodied in the Banking Law and related acts, introduced in September 2001. Although relatively recent, the law covers the main topics of CG (board composition, audit committee, financial disclosure, related party transactions) and it is quite comprehensive. Several regulations have been modified or established to strengthen CG guidelines. While locally owned banks generally abide by the mandatory governance requirements of the banking law rather than establishing their own codes above and beyond these, the dominant banks in the system generally conform to their parents' more stringent CG codes.

The board of directors must have a minimum of five but no more than 15 members and at least 25% of them must be independent. The law clearly defines the concept of independent, and is relatively restrictive. Board structure is commonly one tier, and, therefore, is a mix of executive and non-executive directors. With the exception of the audit committee, the regulations do not require the presence of independent directors on committees. The regulation requires an audit committee to be made up of

between three and five members of the board, including at least one independent director, who will chair the committee.

Although relatively comprehensive on paper, the effectiveness of the CG regulations has not yet been tested in a stressed environment, as the operating environment in Mexico has been generally positive since their implementation. As the country's banks become increasingly integrated with international markets and as the local capital markets continue to grow, it seems likely that those institutions seeking market access will need to convince the markets that, at a minimum, they follow the practices outlined in the code of the banking regulations. Fitch views the progress made on governance by banks in Mexico as a positive step in terms of their creditworthiness, and their ratings are not restricted by CG. Related parties are defined conservatively, although the limit on the sum total of related-party lending, which may not exceed 75% of Tier 1 capital, is less conservative.

Financial disclosure is good. All banks are required to publish a set of wide and detailed information in addition to consolidated financial statements on a quarterly basis. Further disclosure is provided for most balance sheet and income statement items, and a management discussion and analysis commentary is generally available from the major banks.

Turkey, Middle East and Africa

Turkey

After the economic crises of 2000 and 2001, Turkey's Banking Regulation and Supervision Agency made changes in banking regulation and supervision to make CG more transparent. Prevalent related party lending had been a major cause for the failure of over 20 banks, which were transferred to the Savings Deposit Insurance Fund between 1998 and 2002. Regulations to limit related party lending have been established (maximum of 25% of the bank's equity by 2006 and 20% by 2007).

Over half of the system's assets are in the hands of banks quoted on the Istanbul Stock Exchange. In June 2003, the Capital Markets Board of Turkey issued CG principles requiring quoted banks to comply with certain standards for disclosure, shareholder protection, board of director functions and remuneration. This was extended to all banks in October 2005 under the Financial Services Act, which replaced the Banks Act.

Middle East

CG does not come near the top of the agenda for banking systems in the less developed countries of the Middle East. These banking systems include both conventional and Islamic banks, and Fitch has not observed any notable differences in CG between the two. Some of the Gulf countries have been active in putting CG codes in place, although in general the effectiveness of these in practice may be overridden by the influence of ruling families. The cultural issues around how banks and companies are owned and how business is done suggest that international CG codes are unlikely to take root in substance. Despite large numbers of highly professional "expat" staff from western Europe and the US in the banks' management teams, the countries' extended ruling families own most of the banks and retain tight control through supervisory boards that tend to consist of representatives of the families rather than real "independents". Related party transactions remain a major issue, and insider trading is a condoned feature of the Gulf markets.

A gradual move towards better risk management systems in the Gulf States is having a positive influence on CG. Many critical issues, such as related party lending, have both a risk management and a CG element; banks are aware of the implication of weak risk management and are beginning to address this subject. Many banks include thorough descriptions of their CG in their annual reports. Greater CG awareness has also developed from the documentary requirements of the EMTN programmes that many banks in the region have undertaken.

Capital markets regulators in the Gulf have generally been much slower to deal with CG issues. This means that, while a bank's management may be aware of the issues and disclosure practices may be good, there is still little evidence of CG practices among corporates in the region. Oman is an exception (see below.)

Bank regulations on related party lending in Bahrain and Kuwait are fairly stringent on the face of it (see table below). However, these requirements only address first-order related party exposure. Taking into account second/third-order related party exposure, the situation becomes more complicated as many of the companies and their owners are interrelated; this partly reflects the countries' small and undiversified economies.

Bahrain

The rulebook of the Bahrain Monetary Agency ("BMA") stipulates a CG code for banks based in Bahrain. These provisions are more stringent than those required under the existing Bahrain commercial law. Fitch considers these regulations to be comprehensive and well enforced. The BMA rulebook sets out the duties and responsibilities of the board in great detail.

The BMA's rulebook stipulates that the chairman must be non-executive and independent and that the same person may not carry out the role of chairman and chief executive. Boards must have an adequate number of independent and non-executive members to serve the interests of minority shareholders and other stakeholders. The BMA will consider the suitability of nominees for the roles of director, chief executive, general manager and manager. It requires all banks to secure its prior, written approval before making such appointments.

Kuwait

In Kuwait, the chairman of the Commercial Bank of Kuwait (rated 'A–'; 'C') was able to corner the market of a new IPO issue for himself in 2H04 although the Central Bank of Kuwait ("CBK") did intervene and forced a replacement. The CBK's prudential regulations address CG issues such as related party lending and requirements for board/executive staff membership. Fitch considers these regulations to be comprehensive and well enforced. However, the prudential regulations do not extend to CG issues that lie beyond the remit of the CBK. Insider trading, for instance, is prevalent in Kuwait as it is throughout the region.

The CBK has issued requirements, focusing on the appointment process, for board/executive staff membership, which are aimed at ensuring that members have the proper levels of skill and experience. Getting CBK approval for board/senior management nominees is more than a "rubberstamp" exercise. In fact, it can be a rather drawn-out process whereby multiple candidates are rejected before a bank finds an acceptable candidate. The CBK has also issued a manual on the 'Duties and Responsibilities of Banks' Board Members'.

Oman

Oman is the only Middle Eastern country with a CG code, which was established by the Capital Market Authority in 2002. The code gives detailed guidance for all companies listed on the Muscat Securities Market ("MSM"), which includes the main domestic banks. The code includes guidance on the composition and functions of the board of directors, independent and non-executive directors, related party transactions, the audit committee, audit and internal control and management. Companies are required to make CG disclosures in their annual reports; guidance on required disclosures is given within the code.

The banks are predominantly owned by local shareholders, and four of the main five domestic commercial banks are listed on the MSM. In practice, directors tend to be representatives of the banks' main shareholders or significant shareholders themselves. Fitch is not aware of any recent banks breaching the code.

Qatar

The prudential guidelines of the Qatar Central Bank ("QCB") prescribe minimum CG principles that govern the role and responsibilities of the board of directors, although there remains little guidance as to its constitution. Although all board appointments require QCB approval, there are no prudential guidelines governing the independence or experience level required of a board.

Saudi Arabia

As the largest economy in the Gulf region, the influence of ruling families in Saudi Arabia is more diluted than in the smaller countries, leaving room for the legal implementation of CG to have more effect.

Although there is no formal CG code, the banks have seen increasing regulatory oversight from the Saudi Arabia Monetary Agency ("SAMA") and the Capital Markets Authority ("CMA"). The CMA was established in 2003 to develop and regulate a domestic capital market in the region's largest economy. The banks' boards of directors tend to be one tier, with members being significant shareholders or their representatives.

Related party transactions occur at all banks and are subject to SAMA regulatory limits. SAMA has maintained a high level of regulatory supervision and has shown a strong tendency to support the banks. Four banks benefit from the CG knowledge of their joint venture partners: Saudi British Bank (rated ‘A’; ‘B’, with HSBC), Banque Saudi Fransi (rated ‘A’; ‘B’, with CALYON), Saudi Hollandi (rated ‘BBB+’; ‘B/C’, with ABN AMRO) and Arab National (rated ‘A–; ‘B/C’, with Arab Bank). Samba Financial Group (‘A’; ‘B’) may also benefit from the knowledge retained by bank personnel from its previous joint venture partner Citigroup Inc. (‘AA+’), which was a shareholder until May 2004. Generally CG is moving in the right direction as the banks improve risk management policies and prepare for Basel II.

UAE

There is no formal CG code in place at either the federal level or in the individual emirates. However, in December 2005, the UAE Central Bank made an agreement with the International Finance Corporation (“IFC”, the private sector arm of the World Bank) to develop a CG structure for the UAE. Although no specific timetable was provided, it appears that the process has begun, with IFC and the Central Bank hosting a CG workshop for the banks in March 2006.

CG in the UAE shows similar characteristics to that of the other Gulf countries. Boards are typically one tier, with the vast majority of directors being significant shareholders or their representatives. Directors are not prevented from sitting on the board of more than one bank. Related party transactions do occur with limits closely monitored by the Central Bank. A number of the larger banks have substantial government shareholders (Emirates Bank International (rated ‘A’; ‘B/C’), National Bank of Abu Dhabi (‘A’; ‘B/C’), Union National Bank (Abu Dhabi) (‘A–’; ‘C’), Abu Dhabi Commercial Bank, and as such tend to have high levels of government lending and deposits. The annual reports of the banks do not disclose the existence of audit or executive compensation committees nor do they show aggregate executive compensation.

Generally the banks are improving their CG as they are increasingly accessing the capital markets and preparing for the implementation of Basel II. HSBC Bank – Middle East Limited (‘A+’; ‘B’) is probably the most advanced in CG terms as it benefits from being a 100%-owned subsidiary of one of the world’s largest international banks.

Africa

Fitch rates banks in Nigeria and Kenya, countries that have both suffered from poor levels of CG. During November 2005 and January 2006, the Central Banks of Kenya and Nigeria released new prudential guidelines in an effort to improve CG. Fitch will be monitoring how successfully these are implemented.

South Africa

The South African banking system is an exception in Africa in many ways, of which CG in just one. The South African regulatory framework is akin to that in a developed market. There have been several CG breaches in the banking sector, although the majority were confined to small and medium-sized institutions. The lessons learned from these and other failures, locally and internationally, resulted in the appointment of John Myburgh SC and a team from the Bank Supervision Department to review the status of CG within South Africa's largest five banks, then (2002) representing 86% of the system's assets. The outcome was presented in a report to the registrar of Banks during 1Q03.

After the release of the Myburgh Report, changes were introduced to the Banks Act by the promulgation of the Banks Amendment Act 2003. The main aim of this Act was to strengthen CG with banks following Advocate Myburgh's findings. The main amendments included providing the Registrar of Banks certain powers in the appointment and dismissal of a bank's and controlling company's board members and executive officers; and to compel all banks to establish a risk committee and directors affairs committees in the interest of sound risk management and CG. During 2004, the regulator expanded its CG review to consider the remaining banks in the system. This review found CG of the majority of the banks to be sound although the following areas were found needing more attention: compliance function, director selection and continuous training and updating the skills of all directors.

During 2003, the financial problems uncovered at Nedcor (now known as Nedbank Group Limited (rated 'BBB'; 'C') were principally traceable to poor management decisions, including weak lending and funding procedures, foreign exchange exposure and ill-advised investments. However, they also included CG shortcomings; the board did not appear to have taken an active enough role in supervising the bank.

Table 1: Key Regulatory Initiatives

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Asia					
China CG code issued by the People's Bank of China (2002) and the Chinese Banking Regulatory Commission (2006).	Joint stock commercial banks and state-owned commercial banks.	At least two board members should be independent. Senior manager representation on the board should not be less than $^1/_4$ and should not exceed $^1/_3$ of the total members.	Loans to any single related party should not exceed 10% of net capital. Loans to any single related party group should not exceed 15% of net capital. Loans to all related parties should not exceed 50% of net capital.	An audit committee chaired by an external auditor must be established. Otherwise, there is no requirement to have independent members.	A remuneration committee must be established. There is no requirement to have independent members.
India Clause 49 of the Listing Agreement required by Securities and Exchange Board of India.	All listed entities.	33% of directors to be independent (external) directors if the chairman is executive. 50% if the chairman is non-executive.	A statement of all transactions with related parties including their basis shall be placed before the audit committee for formal approval/ ratification. If any transaction is not on an arm's length basis, management needs to justify it to the audit committee.	An audit committee comprising a minimum of three members should be set up. All members should be non-executive directors and the majority, including the chairman, should be independent.	While it is mandatory for a company to have a compensation committee to decide upon the remuneration of the executives under the Companies Act, it is a non-mandatory recommendation under the listing agreement.
Indonesia Bank Indonesia regulation number 8/4/PBI/2006 on GCG Implementation by Commercial Banks, issued on 30 January 2006.	Commercial banks including branch offices of foreign banks.	The supervisory board or board of commissioners ("BOC") must have no less than 50% independent members. The president director/chief director of the board of directors "BOD") must be independent from the controlling shareholders; the majority of BOD members are prohibited from having family relationship up to the second degree with other members of the BOD and BOC.	Provision of funds to related parties is subject to Bank Indonesia regulation on commercial bank legal lending limit, i.e. no more than 10% of the bank's total capital.	An audit committee is required. Its composition should include one independent commissioner and two other independent members, with expertise in finance or accounting and legal or banking respectively.	A remuneration and nomination committee is required, headed by an independent commissioner. Remuneration policies and packages for BOC and BOD must be disclosed in the bank's submission of its GCG implementation report every year.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Philippines The Securities and Exchange Commission ("SEC") implemented the Code of Corporate Governance in 2002. In addition, following the comprehensive amendment of the General Banking Law in 2000, the Bangko Sentral ng Philipinas ("BSP"), the central bank of the Philippines, has legal powers to enforce fit and proper standards for bank directors and key officers, as well as minimum qualifications and specific duties of the board of directors to strengthen board oversight.	The SEC Code applies to all listed entities. The General Banking Law applies to all licensed banks.	The SEC Code requires that independent directors comprise 20% of the board of public companies or that there are two independent directors, whichever is lesser. In addition, the BSP requires at least five members to be on the board of directors.	Banking regulations limit the amount of individual loans to directors, officers, stockholders and related interests ("DOSRI"), of which 70% must be secured, to the total of their respective deposits and book value of their respective investments in the bank. In aggregate, loans to DOSRI should not exceed a bank's total capital funds or 15% of the total loan portfolio, whichever is lower.	Required under the SEC code.	Required under the SEC code.
Thailand Series of Bank of Thailand ("BOT") notifications, which prescribe a commercial bank's board structure, criteria for senior management, prohibition on directorship in other companies, related party transactions and information disclosure. Stock Exchange of Thailand ("SET") introduced 15 good CG principles for listed companies as a guideline for listed companies. SEC issued regulations on roles and responsibilities of independent directors and audit committees and disclosure of compliance with CG principles in annual report.	BOT's notifications apply to commercial banks. SET's CG principles apply to listed entities on a voluntary basis. SEC regulations apply to listed companies.	Executive directors involved in day-to-day management, must not exceed one-third of the BOD of a commercial bank. The BOD should have at least three independent directors, or at a proportion of one independent director to four directors, whichever is higher.	Investment in or loans to related parties is limited to no more than 50% of the related party's shareholders' equity or 25% of its liabilities or 5% of the bank's Tier 1 capital, whichever is lower. The bank must implement a policy on investment in or granting loans to related parties. At a minimum, a transaction must be conducted in accordance with BOT's prescribed practices and be approved by the BOD unanimously and with no participation of the beneficiary party.	Audit committees are compulsory and must comprise at least three members, two of which should be independent directors. The chairman of the committee should not serve on other committees.	Remuneration committees are voluntary. The committee should have at least three members, all non-executive, and should be chaired by an independent director.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
CEE **Kazakhstan** Code adopted by Council of Securities Market Issuers in 2005.	Compliance with the code was made compulsory by the local stock exchange for all entities with listed equity or bonds (i.e. all major banks). Banks have already adopted or are adopting CG codes, although compliance may be in form rather than substance in some areas.	Under corporation law, the BOD must consist of at least three members. At the same time, independent directors must account for no less than one-third of the BOD. Independent candidates should be preferred at board elections.	Banking regulations dictate that related party transactions cannot be made under more favourable terms than agreements concluded with other persons/entities. Unsecured loans to related parties are forbidden. The BOD must approve all related party transactions. Lending to a related party is limited to no more than 10% of total capital	Recommended under the CG code.	Disclosure is recommended under the CG code.
Russia Code adopted by securities market regulator in 2002. Russian exchanges also have CG requirements for companies listing equity or bonds. CG recommendations issued by the Central Bank in H205.	2002 Code and 2005 Central Bank recommendation are voluntary, although exchanges were recommended by Federal Financial Markets Service to make the former compulsory for companies seeking 'A' grade securities listings. Exchange requirements are compulsory but do not always match those of the code. Furthermore, only a few banks have securities listed and adherence can be more in form than substance.	Under the law the number of executives (involved in day-to-day management) must not exceed one-fourth of the total number of members of the BOD. The CG code also recommends that the number of independent directors should account for at least one-fourth of the BOD. Independent candidates should be preferred at board elections.	According to banking regulations, all related party transactions must be undertaken on market terms and approved by the BOD. The Central Bank requires that loans to 'insiders' (primarily executives and direct shareholders, but usually not including other related parties) should not exceed 3% of equity.	Required under the CG code. Recommended that this included only independent directors. If this is not possible, the committee should be headed by an independent director and its members should not include executive directors.	Remuneration committee is required under the CG code. It is recommended that the committee is staffed exclusively with independent directors or, at the least, is headed by an independent director and does not include executive directors. In accordance with the code, remuneration for all BOD members should be equal and disclosed.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Ukraine CG recommendations adopted by securities market regulator in 2003.	CG code is voluntary.	The CG code says that at least one-quarter of members of the BOD should be independent.	Related party transactions at below market rates are not prohibited by the banking law, but the law states that these are permissible as long as "a bank's profit allows this without any harm to the bank's financial development". Furthermore, loans to any single 'insider' (primarily executives and direct shareholders, but usually not including other related parties) should not exceed 5% of share capital. Total lending to insiders is limited to no more than 30% of share capital.	Compulsory under the CG code. The audit committee should be composed of independent members. They may be elected and dismissed only by the general shareholders' meeting.	The CG code recommends that the majority of members of the committee for compensation and remuneration should be independent. Information about total amount and form of compensation of members of the executive board should be discussed.
Czech Republic 2001 CG code, updated 2004, Czech Securites Commission.	Voluntary. Companies with either traded shares or bonds should comply or explain.	Two tier, in most cases CEO is not on the supervisory board. Recommendation that at least half the supervisory board be independent, but this is not always met.	Material related party transactions should be disclosed. The management board is responsible for monitoring related party transactions under the supervision of the supervisory board.	Recommended and generally present. Should be drawn from the supervisory board but does not explicitly state requirement for independents.	Recommended but not usually present. Should be drawn from the supervisory board but does not explicitly state requirement for independents.
Estonia CG recommendations adopted by Financial Supervision Authority in January2006.	Voluntary. Companies with listed equity must either comply or explain non-compliance.	At least half of the members of the supervisory board of the issuer should be independent.	Members of the management board shall promptly inform other management board members of any conflict of interest. Must act in best interests of company and treat all shareholders equally.	Optional.	Determined by the supervisory board.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Hungary Budapest Stock Exchange published "CG Recommendations" in 2004.	Listed entities on a comply or explain basis.	Two tier is standard. Suggestion that the supervisory board should contain independent members but does not recommend minimum.	Relationships of the BOD with third parties that might influence the operation of the company shall be disclosed in the annual report.	Optional. It should consist of at least three members with a majority being independent.	The system of the BOD remuneration will be assessed by the supervisory board and approved by shareholders. A remuneration committee is recommended.
Latvia Riga Stock Exchange published "CG principles and recommendations on their implementation", effective January 2006.	Voluntary. Companies with listed equity must either comply or explain non-compliance.	Two-tier system. Recommended that at least half of the supervisory board members are independent.	The management board will adopt decisions irrespective of their personal interests, and must treat all shareholders equally. The management board members should not participate in any decisions that could result in a conflict of interest, and must notify other management board members on the occurrence or possibility of a conflict of interest.	Optional.	Remuneration policy stating the main determinants of remuneration and possible remuneration schemes should be established by the supervisory board.
Lithuania CG code issued by the National Stock Exchange of Lithuania in 2004.	Voluntary.	A two-tier system is recommended. No requirement for independent members; number is for company to decide.	Significant related party transactions should be approved by the supervisory board.	Recommended.	Recommended.
Poland 2002 "Best Practices in Public Companies" issued by the CG Forum, updated in 2005.	Listed companies only.	Two-tier system. At least half of the supervisory board should be independent.	Transactions with shareholders and other persons, whose interests affect those of the company, should be carried out at arm's length.	Audit committee should be set up and should include at least two independent members.	Remuneration committee should be set up and should include at least two independent members.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Slovenia CG code, published by the Managers' Association, the Stock Exchange and the Association of Supervisory Boards' Memebers (2004, updated 2005).	For listed companies, although also recommended practice for all companies. Contains some obligatory standards and some recommended standards.	Two-tier system. The supervisory board should have a majority of independent members.	All shareholders must be treated equally, and management board members cannot put their own interests ahead of the company, or make financial gain from the company's business opportunities.	Not obligatory.	Determined by the supervisory board. The latter may set up a remuneration committee, but this is not obligatory.
Latin America **Brazil** Comissao de Valores Mobiliaros ("CVM"). The IGBC, the Brazilian Institute for CG, an independent association established in 1995 has also gained importance as a disseminator of CG best practices in the local market and publishes a CG code but it is not binding.	Listed entitles. A number of the major banks must also comply with US SEC and SOX given their profile as active debt issuers in the US. BOVESPA has identified a group of publicly traded entities that follow CG stricter guidelines that the CVM minimum; participants make up less than 10% of listed companies but include the three leading privately held banks.	Generally one tier. The BOD should consist of five members; independents should constitute the "maximum possible" number of board members. Chairman and CEO should not be the same individual.		Audit committees are required by the Central Bank. They must contain at least two independent directors and be chaired by an independent board member.	Large banks generally have constituted several board committees to deal with, inter alia, compensation. The participation of independent directors on these committees is limited.
Chile Ley de Sociedades Anonimas ("LSA") and additional guidelines set by the SBIF, the bank regulator.	All corporate entities must abide by the LSA and financial institutions to the guidelines of the SBIF.	The LSA dictates that a single BOD must be created with f5-11 members; there are no specific requirements for independent directors. The local pension funds hold minority positions in the listed banks, and have encouraged the appointment of independent, professional directors.	Limits in place. Furthermore. Regulations dictate that related party lending must be done on market terms and pass the scrutiny of the committee of directors.	Required under the LSA, with at least three directors, at least two of which should be independent. Also required by SBIF: at least two independent directors, one which has to preside. The LSA also prohibits directors from being employees of the entities they govern .	No specific requirement. LSA attributes oversight of compensation processes and plans for executives to the audit committee.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Mexico Banking Law and related Acts (September 2001)	All banks.	Commonly 1 tier. The BOD must have f5-15 members. At least a quarter of members must be independent. The law clearly defines the concept of independence and is relatively restrictive.	Related party loans must be approved by 75% of the board members (with affected members and/or executives abstaining) and cannot go over 75% of Tier 1 capital.	Audit Committee required. Made up of between three and five members of the board, at least one of which must be independent, who acts as chairman. The regulation defines the committee's functions as setting controls and policies, the ethics code, internal and external audits, and criteria for financial reporting.	The board commonly delegates the compensation committee, but there is no requirement to have independent members.
Turkey and Middle East **Turkey** CG code issued by the Capital Markets Board of Turkey (2003) CG code issued within Financial Services Act (2005).	Listed entities (2003) Extended to all banks (2005).	At least one-third of board and at least two members and the chairman must be independenrt.	Limited to 25% of equity as of 2006; 20% as of 2007.	Required - in charge of financial and operational activities. Must convene at least quarterly with an external audit firm participating.	No committee required per se. Executive compensation should be compatible with qualifications and contributions to the success of the company. It should be determined in accordance with market conditions.
Bahrain CG code included in the rulebook of the Bahrain Monetary Agency.	Banks based in Bahrain.	The rulebook requires an adequate number of independent members (including the chairman).	A bank may not incur an exposure to an individual counterparty or group of closely related counterparties, which exceeds 15% of the bank's consolidated capital base. In addition, exposures to all related parties when combined may not exceed 40% of a bank's consolidated capital base. Exposures to related counterparties may be justified only when undertaken for the clear commercial advantage of the bank (i.e. negotiated and agreed at arm's length).	Mandatory for all Bahraini banks. Members must have sufficient technical expertise to enable the committee to perform its functions effectively.	No committee required.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Kuwait CG code included in the prudential regulations of the Central Bank of Kuwait	Banks based in Kuwait.	No specific guidance on independent members, although members must be approved by the Central Bank of Kuwait.	Credit exposure to any borrower should not exceed 15% of a bank's regulatory capital. Debtor parties that are in effect economically or legally associated and interrelated are considered as one single borrower. In addition, lending to related parties should not jointly exceed 50% of a bank's regulatory capital.	Mandatory for all Kuwaiti banks. Members must have sufficient technical expertise to enable the committee to perform its functions effectively.	No committee required.
Oman CG code in place, set up by the Oman Capital Market Authority.	Companies listed on the Muscat Securities Market.	One tier. Majority of board must be non-execs. A minimum of one-third of the board must be independent (min. of two). Non-execs and independents must be identified in the annual report.	Limits from the Central Bank are in place and guidance is provided in the code. Related party transactions must be on fully commercial terms, monitored by the audit committee and reported to the Central Bank.	Required by the code. Must have at least three members, all of whom must be non-execs and the majority must be independents.	Not required by the code.
Qatar No formal CG code in place.	n.a.	No specific guidance on independent members, though members must be approved by the Qatar Central Bank.	Various prudential limits govern the extent of related party lending, with all credit facilities to a credit group of one member of the board of directors and his family members limited to a maximum of 7% of a bank's capital, provided that these facilities are adequately secured. Gross lending to all directors should not in total exceed 35% of a bank's capital and be adequately secured.	Required by QCB regulations.	No committee required, but details advised to the general meeting.

Governance Codes and Practices	Applies to	Board Independence	Related - Party Transactions	Audit Committee	Executive Compensation
Saudi Arabia No formal CG code in place.	n.a.	One tier. Members are mostly major shareholders or their representatives; sometimes there are some independent members.	SAMA regulatory restrictions in place and closely monitored.	All banks have audit committees, typically made up of three board members.	No committee, although aggregate compensation is disclosed in the accounts.
United Arab Emirates No formal CG code in place.	n.a.	One tier. Members are mostly major shareholders or their representatives. Sometimes some independent members.	Central Bank of the UAE restrictions and monitoring.	Do not appear to have been established.	No committee or disclosure of aggregate executive compensation.
Africa **South Africa** The King II Report on CG for South Africa (2002). Voluntary.	Adopted by most public companies in South Africa as the industry-wide CG code. The five largest banks make mention of the fact that they comply in all material respects.	A one-tier system comprising a mix of executive and non-executive directors. The roles of the CEO and chairman are in all instances separate.	Board must approve all credit exposures (excluding those to government and banks) in excess of 10% of qualifying capital and reserves of the bank.	Audit committee set up with some non-executive members either chairing or sitting on the committee.	Remuneration committee set up with some non-executive members either chairing or sitting on the committee.

Source: Fitch

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