

Caribbean Corporate Governance Forum

The Role of Banks in Corporate Governance

Luigi Passamonti

The World Bank

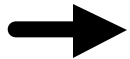
St.Kitts

September 4, 2003

Definition

“Corporate governance are the set of arrangements that maximize the incentives for value-enhancing investments while minimizing inefficient power seeking.”

-Prof. L.Zingales



It is the issue of how to get managers to work for shareholders and majority shareholders to work for all shareholders

The Main Function of Banks

- To mobilize savings into productive investments
 - To screen creditworthy borrowers and projects
 - Appropriate lending policy
 - To monitor use of borrowed funds as intended
 - Appropriate credit administration
 - Supported by sound corporate governance
 - To ensure recovery of loaned amounts
 - Enforcing creditors' rights
 - Through possible restructuring of loan terms



A critical role in upholding incentives
for value-enhancing investments

The Role of Banks in Corporate Governance

Considerations

- Most influential role among contractual corporate suppliers
- Their negligence could lead to serious governance lapses
 - Role of banks in recent corporate collapses
- Large role in special situations
 - Corporate restructuring situations
 - Short-term maturities
 - Weak creditors' rights context
- Large role also when high financial leverage
 - Germany and Japan examples
 - But is it conducive to maximizing value-enhancing investments?



Key Issue: Does strong creditor influence help (small) shareholders?

The Role of Banks in Corporate Governance (2)

Potential Shortfalls

- A diversified financial system offers a more resilient credit intermediation service to the economy
- Strong bank relationships do not foster transparency and disclosure
- High leverage made possible by bank loans may stifle other funding sources with complementary management disciplining effects
- Special issues related to ownership of banks
 - Conglomerates (connected lending)
 - Government
- ...and to their official supervision arrangements
 - Any unintended indirect influence on corporate governance?

Quis Custodiet Ipsos Custodes?^{1/}

- Corporate governance of banks is an essential element of a country's governance architecture
 - It can have systemic financial stability implications
 - It can shape the pattern of credit distribution and overall supply of financial services
 - It can set the tone for corporate governance in the non-financial sector

^{1/} “Who is to guard the guards themselves?” -Juvenal, Satires

Bank Governance

Main Issues

- Authorities play a direct role in bank governance through bank regulation and supervision
 - Unlike in the corporate world
 - Justified by financial stability and deposit insurance liability considerations
 - Acting almost as a “parallel” owner
- Shareholders enjoy the benefit of high leverage with the downside protection of deposit insurance
 - Weakened incentives for strong management monitoring



Key Issue: Who controls management? Boards or bank supervisors?

Bank Governance

Current Trends

- Stronger emphasis on risk measurement and management by Basel II
 - Helps monitor management actions
- Emerging role of “market discipline” as a complement to bank supervision
 - Sanctioned by Basel II (Pillar 3)
 - Particularly by uninsured bank creditors
- But still room to enhance shareholder discipline
 - Essential to further financial stability without stifling financial innovation

Bank Governance

Some Suggestions

- Supervisors should help board and shareholders exercise discipline – and not supplant them
 - Shareholders are essential pillars of market discipline
 - Their incentives must be made to align with those of authorities
- Supervisors must make boards main locus of accountability
 - While keeping open communication channels with management
 - Management to be made accountable to board, not to supervisors
- Supervisors should assess board effectiveness
 - Particularly sub-committee work
 - Audit committee critical for accuracy of information
 - Role of independent and non-executive directors
 - Special situations of foreign-owned banks

The Role of Banks in Corporate Governance

Conclusions

- Banks are important stakeholders of corporations
 - Their actions can affect corporate performance
 - Both positively and negatively
 - But their influence as lenders should complement effective shareholder monitoring and protection of minority rights
- Governance of banks is an essential element of a country's governance architecture
 - Enhanced role for shareholders and boards, helped by bank supervisors