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CORPORATE GOVERNANCE IN BANKING ACTIVITIES

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Abstract

In the modern society the banking system occupies a very important place; it can decisively influence the economy as a whole and the quality of our lives. Therefore its proper functioning is of vital importance. For the well being of a society, lending to both retail and corporate sectors is very important. When talking about the lending rules for companies it is much easier to do a cost-benefit analysis, subjectivity occurs mainly in case of retail credit.

Taking into consideration the recent bankruptcies that took place all over the world, we consider this to be one of the best moments to speak about banking ethics. This article is aiming to make a comparison between the ways in which corporate governance in banking are applied in emergent economies compared to the developed ones. To achieve this objective we examined some characteristics of corporate governance in banking in general, related to some special features of the developing countries and we made an overview of the Romanian financial system.

Keywords: banking, corporate governance, emergent economies, banking ethics.
JEL classification: G30

Corporate governance it is considered to be a relative new concept but we can deduce that its existence was put in appearance by Adam Smith in "The wealth of nations" : "Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company". There is a very important correlation between management and the appliance of sound corporate governance principles in all areas of work.

Studies have shown that given the importance of banks, the governance of banks themselves assumes a central role. "If bank managers face sound governance mechanisms, they will be more likely to allocate capital efficiently and exert effective corporate governance over the firms they fund. In contrast, if banks managers enjoy enormous discretion to act in their own interests rather than in the interests of shareholders and debt holders, then banks will be correspondingly less likely to allocate society's savings efficiently and exert sound governance over firms." [Hennie van Greuning, Sonja Brajovic Bratanovic Analyzing Banking Risk]

Ross Levine's studies on bank management proved that proper functioning of banks has ramifications for the operations of firms and the prosperity of nations through the following channels:

- banks are critically important for industrial expansion,
- the corporate governance of firms,
- capital allocation.

The economist's researches have determined the effects of efficient mobilizing and allocation of funds:

- lowers the cost of capital to firms,
- boosts capital formation,
- stimulates productivity growth.

Banking crises can be considered the consequences of poor governance of banks. That leads us to the conclusion that the causes of the crises of which we are affected nowadays have their roots in corporate governance in the financial sector.

Applying sound principles of corporate governance in banking is of vital importance due to the fact that banking crises are known to:

- Weaken economies,
- Destabilized governments,
- Increase poverty all over the world.

Like in any other field of work, when bank insiders exploit the bank for their own purposes, this can increase the likelihood of bank failures.

The importance of the financial system alone does not motivate a separate analyze of corporate governance in banking institutions. The reason for which this subject is as well as actual as important is that banks are corporation.

Banks have:

- shareholders,
- debt holders,
- boards of directors,
- competitors

These characteristics numbered above determine us to think about the governance of banks in the same way that one thinks about the governance of any other type of company.

The uniqueness of bank corporate governance is expressed also in researches performed by Adams and Mehran (2003). Their sample for analysis consists of thirty-five bank holding companies (BHCs) over a ten years period of time - the 1986-96. Their analyze determine us to conclude the following differences between financial companies and corporations that activate in different fields of bussines :

- On average, banks have a bigger board size,
- Larger percentage of board directors,
- More committees and meet slightly more frequently,
- Measured in percentage terms, the ratio of chief executives' stock option pay to salary plus bonuses and the percentage of CEO direct equity holdings are smaller at banks.

The authors suggest that "these differences are due to the differences in the investment opportunities of BHCs and manufacturing firms as well as to the presence of regulation".

At empirical level we can state that corporate governance principles can be considered the mechanism through which shareholders are assured that managers will act in their interests.

Never the less corporate governance in banking sector is related to its specificity and unique features. According to Stijn Claessens banks are "special" different from other corporations:

- Opaque, financial information more obscure: hard to assess performance and riskiness;
- More diverse stakeholders (many depositors and often more diffuse equity ownership, due to restrictions): makes for less incentives for monitoring;
- Highly leveraged, many short-term claims: risky, easily subject to bank runs;
- Heavily regulated: given systemic importance, as failure can lead to large output costs, more regulated;

"Corporate governance relates to the manner in which the business of the bank is governed. It is defined by a set of relationships between the bank's management, its board, its shareholders, and other stakeholders.

This includes:

- setting corporate objectives and a bank's risk profile,
- aligning corporate activities and behaviors with the expectation that management will operate the bank in a safe and sound manner,
- running day-to-day operations within an established risk profile and in compliance with applicable laws and regulations, while protecting the interests of depositors and other stakeholders".[Hennie van Greuning, Sonja Brajovic Bratanovic Analyzing Banking Risk]

Many governments, even the most liberal ones, have the tendency to over regulate the banking system behavior in order to obtain a prudent allocation of capital [Benston and Kaufman, 1996; Barth et al., 2006]. Banking studies on the impact of a bank's ownership structure related to national and international regulation have little appliance in the real economy.

Shleifer and Vishny studied corporate governance systems around the world regarding :covering shareholders' legal rights:

- ❖ the monitoring role of banks as creditors,
- ❖ concentrated ownership structures that result from leveraged buyouts(LBOs).

They identify three principal governance systems:

- US and the UK characterized by strong shareholder rights,
- Germany characterized by large shareholders system and weak shareholder rights,
- Japan as a optimal combination between US, UK and Germany.

This classification stated above is considered the stepping stone regarding the appliance of corporate governance principles by many well known economists.

1. CORPORATE GOVERNANCE PRINCIPLES

1.1. The Organization for Economic Cooperation and Development

The Organization for Economic Cooperation and Development (OECD) is an intergovernmental body with 30 member countries and another 70 committed to democracy and a free market economy. The OECD Principles published in 2004 state that "There is no single model of good corporate governance", and the "mix between legislation, regulation self-regulation, voluntary standards, etc. in this area will therefore vary from country to country". That's why we can draw the conclusion that one model of corporate governance does not fit all. Even thaw it has to be taken into consideration each country specificity's, specialists have found some commune characteristics such as:

- Protecting shareholder's interest;
- Protecting stake holder's interest;
- Maintaining and increasing the public's interest in the banking system;
- Obeying all Central Bank, government and other authorities regulators.

1.2. Basel Committee principles

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision [http://www.bis.org/bcbs/ 2009].

The philosophy behind the Basel Committee governance principles is that sound governance can be achieved regardless of the form used by a banking organization, provided several essential functions are in place.

Corporate Governance for Banking Organizations

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

Corporate Governance for Banking Organizations Basel Committee on Banking Supervision, February 2006]

2. DEVELOPING ECONOMY BANKING

It has been established that corporate governance in banking is of vital importance for all economies. Further more, the corporate governance of banks in developing economies is of greater importance for several reasons:

- Banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth [King and Levine 1993a,b; Levine 1997]
- Given the fact that financial markets that function in the developing countries are usually underdeveloped:
    - banks are the most important source of finance for the majority of firms.
    - banks are usually the main depository for the economy's savings.

In Romania there is a history regarding bankruptcies such as: Bancorex and others. This type of bad practices has crippled peoples confidence in the Romanian financial system.

Research has shown that in many developing countries, the private banking sector is not enthusiastic about implementing corporate governance principles. The ability of developing economies to apply sound governance principles is difficult for different points of view:

- Studies have concluded that the banking system in emergent economies has substantially higher capital requirements than the one that activate in developed economies;
- The economy has been recently privatized
    - ❖ supervisors authorities are not well trained and don't have enough experience in similar situations;
    - ❖ supervisory authorities are politically involved, that's why their position is correlated with the interests of the party they are members of,
    - ❖ accounting rules suffer many changes on short periods of time, reason for which they can be avoided easily.

There is an important correlation between the privatization process in developing economies and the prudential supervision system, in order to forewarn the expropriation of liquidities.

Capital adequacy norms have the role to maintain a high level of trust in the depositor's eyes and to raise the bank's liquidity as well as its capacity to face loans with a high degree of risk.

Trying to harmonize with the developed economies and strongly believing that financial markets self regulate, many emergent countries deregulate their banking system even before applying sound principles of corporate governance.

Solvability is the main index that measures the adequacy of capital. The adequacy of the capital – the solvability – permanently constituted an essential preoccupation of the bank management and of the regulations in the profile, because of its role in the solidity of the bank and the safety of the deposits. "More than that, the adequacy of the capital has also an important competitive dimension, the banks being capitalised, being more attractive for the resources, either from deposits, of from loans, in favourable conditions".[The analysis of the risks and of their effects upon the banking activity Chirita Irina, Ciubotaru Irina Stefania]

According to Arun and Turner, in developing economies, the introduction of sound corporate governance principles into banking has encountered some difficulties such as:

- poor legal protection,
- not enough transparency in their rapports,
- dominant "actors".

3. OVERVIEW OF THE ROMANIAN BANKING SYSTEM

Romania is a developing country. More than 40 banks activate in Romania. Only a small part have significant Romanian shareholders, the rest are just branches of foreign banks. This fact indicates that the banking corporate governance is mainly done outside Romania, in the EU especially in countries such as Austria, Greece, Netherlands or Italy, where the main banking corporations that operate in Romania come from.

Table no 1 Overview of the Romanian banking system

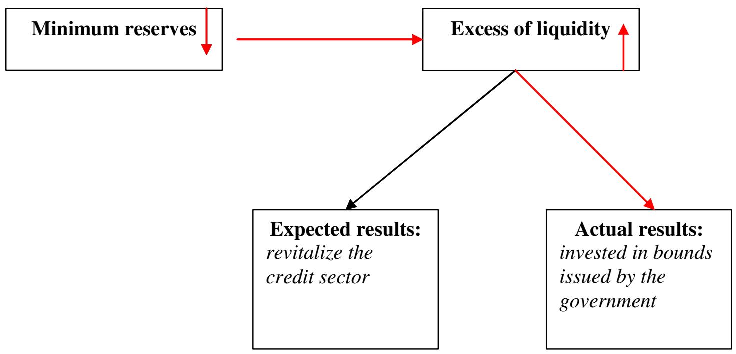
Overview of the Romanian banking system

	2007	2008
Number of credit institution		
Stand alone credit institution	32	33
Banking groups	10	10
Credit institutions	42	43
Domestic credit institution	6	6
Foreign-controlled subsidiaries and branches	36	37
Total assets of credit institution(EUR billions)		
Domestic credit institution		4.88
of which:		
Large		0
Medium-sized		4.3
Small		0.57
Foreign-controlled subsidiaries and branches		39.65

Source: [Romanian National Institute of Statistics]

As noted above the banking system in developing countries is of vital importance to the economy and elimination of poverty but, the system is mainly influenced from abroad. Even so, in a crises situation such as the current period, governments that feared the withdrawing of foreign capital by banking corporations have proven to act not in the best interest of the population. For example, governments have drawn in vast amounts of money from the local market to cover budget deficit leaving the financial market with little liquidity for funding the population as well as the rest of the economy. This can be considered an example of poor policy making with severe consequences on the national economy.

Even though the Romanian National Bank has tried to minimize the effects of the crises on exchange rates and support the banking sector as well as the economy dependent on bank loans, poor budgetary strategy imposed by the government has severely reduced the impact of such measures. One of the regulations imposed by the Romanian National Bank that aimed to increase liquidity on the loaning market implied the reducing of the quantum of minimum reserves. The excess of liquidity was used by the commercial banks for investing in bounds issued by the government because of the high level of interest and low risk. Therefore, the aimed effect of this regulation was not realistic given the facts. If the authorities would have implemented coherent financial policies, the effects would have had a real impact on the economic growth. A pertinent question that comes into our minds is : is this ethical? It's true that the banks have invested in the asset with the best correlation between earnings and risk; nevertheless they should have taken into consideration the real purpose of this regulation.



Source: [www.bnro.ro]
Figure no. 1 Bank's investments

There are voices that sustain that the Romanian banks have not yet reached the critical point that's why they aren't willing to determine structural changes regarding their credit behavior. When the crises began the only safety net that banks relayed on was the "variable interest" that allowed them to increase credit rates without any correlation with economic indexes such as Robor or Euribor.

The credit market of a post communist country was very permissive: people weren't trained to obtain a decent credit and they contented with expensive, non-ethical credits. The banks took advantage of their lack of knowledge and practiced abusive rates of interested corroborated with very restrictive credit contracts. In the fall of 2008 many people had to pay credit rates two or three times higher than at the moment they signed the contract. At that point many have realized that the state didn't do anything to help the population to acquire relevant in formations regarding the biro racy behind the loan. Nowadays there are many families witch are not satisfied with the decision they made a few years ago. This fact noted above correlated with the one that most of the loans are contracted in Euro witch has grown with over 20 percent lead to a very indebted population. We can safely say that Romania is highly indebted while the banking system depends almost exclusively on foreign money. The BNR official said Romanian banks, most of whom are held by credit institutions from European Union countries saw they no longer get resources from parent banks and are focusing much stronger on the domestic market, with savings becoming a priority. The banks operating on the Romanian market last year posted up the biggest revenues from interests and commissions corresponding to their total assets, and also the highest return to equity - ROE, in the entire European Union, according to data released by the ECB (European Central Bank), quoted by *Ziarul financiar* daily.

One other concerning fact in our economy is the fact that real estate prices have collapsed spectacularly; foreign investors have reduced or withdrawn their investments, meaning foreign capital is flowing out of Romania ever more rapidly. Meanwhile, the Romanian currency the "leu" has lost a good quarter of its value in relation to the dollar, meaning foreign exchange credits that are denominated in dollars have increased in price by 25 percent. Romania has seen the creditworthiness of its long-term foreign debts lowered to "BB+", sinking by two ratings. Analysts are questioning the ability of the Romanian state to avoid a "severe financial and economic crisis," reported the *Mediafax* press agency. A worse rating also makes it more difficult for the country to access loans at more favorable rates of interest. While good governance is no doubt a useful objective, there are dangers in applying the beliefs of one country to another without researching their impact.

Shortly we can state that weak points of the Romanian banking system can be considered the followings:

- The danger of the withdrawing of foreign capital by banking corporations;
- Permissive credit market - *abusive rates of interested corroborated with very restrictive credit contracts;*
- The credits are contracted in foreign currency while the incomes are in national currency*;*
- Credits depend almost entirely on the speculative real estate sector;

In a desperate attempt to sustain the real estate sector, the Romanian government launched the "First Home" program imposing some conditions related to the margins of interest practiced by the banks (maximum 4 percent per year over the EURIBOR interest rate at 3 months for credits in euros and a margin of 2.5 percent the most over the ROBOR rate at 3 months for credits in lei).

It follows that the average cut of costs for a person through the "First Home" program stands between 42 percent and 49 percent for credits in euros, still expensive related to the European credit market. Nowadays we are passing through a very important crisis that may change the entire ideology regarding the management of banks and the policy regarding our personal finances. After the well known tend icy of financial markets with low regulation, the governments, frightened by the current situation are trying to endow the harm by imposing restrictive normative. We witness the FED saving from bankruptcy credit corporation based on the principle "To big to fail". A few years ago the privatization of the financial sector was seen as a must, nowadays the wheel turns and the state becomes more involved in its proper function by becoming its creditor and implicitly a stakeholder.

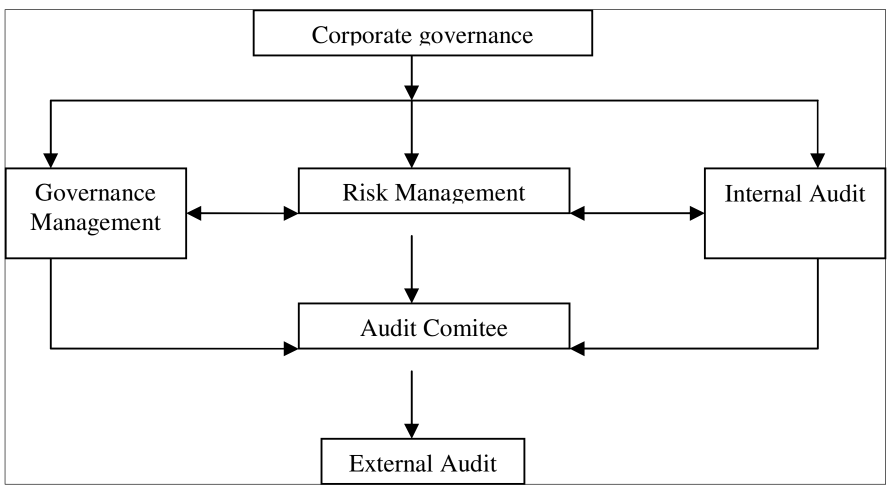
In 1867 Karl Marx stated "Owners of capital will stimulate working class to buy more and more of expensive goods, houses and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to bankruptcy of banks which will have to be nationalized and State will have to take the road which will eventually lead to communism". My point of view is that he was half right : the regulation of the financial system will increase significantly. There are voices that say that the 90 percent taxation on executive bonus payments by companies receiving more than $5 billion in federal bailout funds it's not a democratic action, and it contradicts with the concept of free market economy. The issue is that the government has made a mistake and created an unfortunate precedent: he bailed out some players of the financial market, action that comes into contradiction with democracy. The FED has created a precedent and free competition between banks was not encouraged. If the state wouldn't have interfered, the uncompetitive banks would have been bankrupted. This is a very important lesson and lead to a hard to answer question: how big should a financial institute be in order that the state may not jump into its rescue? The process of globalization affects all areas of the economy and implicitly the quality of our lives. Bank consolidation is a global phenomenon. The present trends at European level regarding the increase of banking concentration affected Romanian banking system, among others. Recent studies have shown that such consolidation may enhance the value of banks in the industry since there appear to be strong scale economies [Stiroh, 2000; Hughes, Lang, Mester, and Moon, 2000;and Hughes, Mester, and Moon, 2001].

It's not safe to have on the market companies "To big to fail", the government does not give a good example intervening in the proper function of the corporations. Sound principles of government in banks lead to sustainable banking and economic growth.

Research has shown that there is a important correlation between the appliance of sound corporate governance principles and audit in all areas of business.

4. THE ROLE OF CENTRAL BANKS IN THE APPLIANCE OF CORPORATE GOVERNANCE PRINCIPLES IN BANKING

It's a well known fact that "all international supervisory and control institutions require the establishment of internal auditing committees" [The Role of the Central Bank in Promoting Corporate Governance, from a speech by Dr. Mahmoud Abul Ayoun, Governor of the Central Bank of Egypt, at a conference on February 5, 2003 hosted by the Egyptian Banking Institute and CIPE], the relationship is illustrated in the following scheme:



Source: [Ghita, M Corporate governance and internal audit, Tipo Moldova, Iasi, 2009]

Figure no. 2 The relationship between corporate governance and audit

This relationship has appliance for enterprises that activate in different areas of business, banks as well. For bank holding corporations the audit has important implications and it's correlated with prudential behavior.

In the era of globalization, international authorities have developed sound regulations in order to prevent bankruptcy. In the implementation of this principles and their adaptation to the specificity of each country's economy the central bank the central banks play an important role.

Studies have shown that central banks play an important role in the proper appliance of corporate governance principles in banking:

- "Supporting the issuance of legislation and systems which would remedy the gaps and insufficiencies in legislation of relevance to good governance, whether at the level of legislation governing banks as companies, or legislation governing their work as banks;
- Encouraging sound practices in banks, ensuring that they have adequate organizational structures, and that their boards of directors and executive functions have practical plans for handling their responsibilities, and possess adequate qualifications and experience in banking and financial activities;
- Emphasizing the responsibility of boards of directors for any problems faced by banks, as well as for taking necessary action to remedy any gaps or infringements related to the work of these banks in a timely fashion;
- Being aware of any signs or indicators of weakness or faults in the management of these banks;
- Enhancing cooperation between those in charge of managing banks and the supervisory authorities;
- Continuously endeavoring to improve the regulatory and supervisory environment so as to foster competition among banking system units, noting that competition is an important factor in encouraging banks to adopt and apply the principles of good governance". [The Role of Central Banks in Defining Corporate Governance in Banks, from a speech by H.E. Sheikh Salem AbdulAziz Al-Sabah, governor of the Central Bank of Kuwait, at the conference Corporate Governance for Modern Banking Performance held in Beirut, Republic of Lebanon, January 13-14, 2005]

As shown above, The Basel Committee recommends Core Principles of Effective Supervision in banking, principles that have a strong impact of the banking market.

Supervision is strongly related to control, the main objective of prudential supervision in to maintain the stability and creditworthiness in the banking system at high standards.

The National Bank of Romania (BNR) plays an intrinsic role in maintaining financial stability, responsibility that resides from its double role: monetary authority as well as prudential responsible.

The Romanian Central Bank (BNR) has established a number of objectives in concordance with the European Union legislation. The process is facilitated by the existence of an adequate legislative framework that regulates the banking process in concordance with the appliance of sound principles of corporate governance.

The reform targets the institutional, structural and operational harmonization of the Romanian banking system. BNR urges the process of harmonization through two channels:

1. Effective adaptation to the European Union financial legislation;
2. Strengthening of administrative capacity of the national bank [*Stabilitatea sistemului bancar şi supravegherea prudenţială în românia*, Lecturer Göndör Mihaela Liliana, University Petru Maior Tîrgu Mureş, Faculty of Economic Sciences, annals]

In order to achieve these objectives, the central bank pays increasing attention to the stability of the banking system, by effectuating a monthly analyze of financial and prudence indicators and a quarterly evaluation of its vulnerabilities and risks exposure: credit, currency and interest, based on a so called “stress test”.

The National Bank of Romania (BNR) has relationships with the following international organisms:

- The International Monetary Found;
- The International Bank for Reconstruction and Development (IBRD);
- European Bank for Reconstruction and Development (EBRD);
- Black SeaTrade & Development Bank.

In consent with the European Union banking Supervision standards, BNR introduced two preventive control measures : the Central Credit Register and the Payment Incident Register.

Central credit register(CCR) is a system specialising in the collection, storage and centralisation of information on the exposure of all reporting entities (credit institutions or non-bank financial institutions enlisted with The National Bank of Romania Special Register)(www.bnro.ro).

The CCR database comprises four files:

Central Credit File	credit risk information reported by reporting entities
Overdue Debt File	credit risk information from the CCF on the cases of failure
Debtor Group File	credit risk information from the CCF about the groups of individuals and/or legal entities representing a single debtor
Card Fraud File	information on card frauds committed by cardholders

Payment incident register(PIR) is an intermediation centre managing information specific to payment incidents both from the bank's point of view (overdraft) and from the social point of view (loss/theft/destruction)(www.Bnro.ro).

The database of the PIR is organized in two files:

Payment Incidents National File	Cheque National File
	Bill of Exchange National File
	Promissory Notes National File
Risky Persons National File	

As shown in chapter 3, the banking system’s role in emergent economies is a even of greater importance than in the developed ones, reason for which the harmonization of Romanian banking system is mandatory. One of the most important operational functions of a national bank consists in providing sound prudential regulations in order to anticipate a possible amplification of the current crises.

5. CONCLUSIONS

Corporate governance is a very important and sensitive issue especially during the current crises. This type of management is strongly correlated with banking ethics – concept which gains more and more attention. We have stated above that ethics stands at the base of any healthy economy. There are banks which try to keep a good image as well in the eyes of the population as in the ones of the Romanian Central Bank by hiding some of their unsuccessful loans. There are some unconfirmed reports which show that a very important financial institute has made a subsidiary and sold all the problematic loans to them, keeping in this manner good reports.

We don't consider this to be an ethical behavior and this kind of back doors should be stopped from the beginning by the authorities by implementing some regulations.

Specialists stated the direct effects of the international financial crisis on Romania are limited: "We have found that the traditional banking products are prevalent, for clear reasons such as a huge profit margin, and, last but not least, cautionary and sometimes administrative measures, harshly criticized by the banking system, have proved useful and have served as a buffer against the crisis effects. Mandatory minimum reserves for instance, serve as buffer stock of liquidity, helping both the country and the banking system, to resist possible foreign shocks."[Mugur Isarescu, 2009]. If we take into consideration the reports mentioned above and the current condition of the Romanian economy as a whole, the governor's prediction doesn't seem realistic.

The financial system has proven than self regulated markets have many drops. This fact corroborated with the huge importance of the banking system and the globalization leads one to the conclusion than strong regulation and monitoring of financial system is the only way to a healthy economy.

There is a very sensitive balance between risk behavior and profits. Bank managers need to be aware regarding the importance of the appliance of sound corporate governance principles.

In Romania this concepts start to gain confidence in the public's eye. Our country has an unique mentality, therefore corporate governance in banking needs to be adapted to the specificity of its financial system. In order to achieve an optimal appliance of them our specialists must keep just the bone structure and adapt the rest.

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