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#### **Corporate Governance of Banks in Developing Economies: Concepts and Issues**

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# Corporate Governance of Banks in Developing Economies: Concepts and Issues

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## Abstract

This paper discusses the corporate governance of banking institutions in developing economies. This is an important issue given the essential role banks play in the financial systems of developing economies and the widespread banking reforms that these economies have implemented. Based on a theoretical discussion of the corporate governance of banks, we suggest that banking reforms can only be fully implemented once a prudential regulatory system is in place. An integral part of banking reforms in developing economies is the privatisation of banks. We suggest that corporate governance reforms may be a prerequisite for the successful divestiture of government ownership. Furthermore, we also suggest that the increased competition resulting from the entrance of foreign banks may improve the corporate governance of developing-economy banks.

## **1. Introduction**

Although the subject of corporate governance in developing economies has recently received a lot of attention in the literature (Oman, 2001; Goswami, 2001; Lin, 2001; Malherbe and Segal, 2001), the corporate governance of banks in developing economies has been almost ignored by researchers (Caprio and Levine, 2002). Even in developed economies, the corporate governance of banks has only recently been discussed in the literature (Macey and O'Hara, 2001). In order to address this deficiency, this paper discusses some of the key concepts and issues for the corporate governance of banks in developing economies.

The corporate governance of banks in developing economies is important for several reasons. First, 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). Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms,. Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy's savings. Fourth, many developing economies have recently liberalised their banking systems through privatisation/disinvestments and reducing the role of economic regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.

In the next section, we argue that the unique nature of the banking firm, whether in the developed or developing world, requires that a broad view of corporate governance, which encapsulates both shareholders and depositors, be adopted for banks. In particular, the nature of the banking firm is such that regulation is necessary to protect depositors as well as the overall financial system. Using this insight, in section 3 we examine the corporate governance of banks in developing economies in the context of ongoing banking reforms. In the penultimate section, we discuss the changing role of government in developing-economy banking systems and the consequences for corporate governance. The final section provides a summary and policy suggestions.

## **2. Corporate Governance and the Special Nature of Banking**

The narrow approach to corporate governance views the subject as the mechanism through which shareholders are assured that managers will act in their interests. Indeed, as far back as Adam Smith, it has been recognised that managers do not always act in the best interests of shareholders (Henderson, 1986). This problem has been especially exacerbated in the Anglo-Saxon economies by the evolution of the modern firm characterised by a large number of atomised shareholders, leading to a separation of ownership and control.<sup>1</sup> The separation of ownership and control has given rise to an agency problem whereby management operate the firm in their own interests, not those of shareholders (Jensen and Meckling, 1976; Fama and Jensen, 1983). This creates opportunities for managerial shirking or empire building and, in the extreme, outright expropriation.<sup>2</sup> However,

there is a broader view of corporate governance, which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they earn a return on their investment (Shleifer and Vishny, 1997, p.737; Vives, 2000, p.1; Oman, 2001, p.13).

We will argue below that the special nature of banking means that it is more appropriate to adopt the broader view of corporate governance for banks. Notably, Macey and O'Hara (2001) argue that a broader view of corporate governance should be adopted in the case of banking institutions, arguing that because of the peculiar contractual form of banking, corporate governance mechanisms for banks should encapsulate depositors as well as shareholders. As we shall see below, the special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to restrain the behaviour of bank management.

Depositors do not know the true value of a bank's loan portfolio as such information is incommunicable and very costly to reveal, implying that a bank's loan portfolio is highly fungible (Bhattacharya et al, 1998, p.761). As a consequence of this asymmetric information problem, bank managers have an incentive each period to invest in riskier assets than they promised they would *ex ante*. In order to credibly commit that they will not expropriate depositors, banks could make investments in brand-name or reputational capital (Klein, 1974; Gorton 1994; Demetz et al 1996; Bhattacharya et al 1998), but these schemes give depositors little

confidence, especially when contracts have a finite nature and discount rates are sufficiently high (Hickson and Turner, 2003). The opaqueness of banks also makes it very costly for depositors to constrain managerial discretion through debt covenants (Capiro and Levine, 2002, p.2). Consequently, rational depositors will require some form of guarantee before they would deposit with a bank. Government-provided guarantees in the form of implicit and explicit deposit insurance might encourage economic agents to deposit their wealth with a bank, as a substantial part of the moral hazard cost is borne by the government.

Nevertheless, even if the government provides deposit insurance, bank managers still have an incentive to opportunistically increase their risk-taking, but now it is mainly at the government's expense. This well-known moral hazard problem can be ameliorated through the use of economic regulations such as asset restrictions, interest rate ceilings, separation of commercial banking from insurance and investment banking, and reserve requirements. Amongst the effects of these regulations is that they limit the ability of bank managers to over-issue liabilities or divert assets into high-risk ventures.

Thus far we have argued that the special nature of the banking firm requires public protection of depositors from opportunistic bank management. However, the special nature of the banking firm also affects the relationship between shareholders and managers. For example, the opaqueness of bank assets makes it very costly for diffuse equity holders to write and enforce



effective incentive contracts or to use their voting rights as a vehicle for influencing firm decisions (Caprio and Levine, 2002, p.2). Furthermore, the existence of deposit insurance may reduce the need for banks to raise capital from large, uninsured investors who have the incentive to exert corporate control (Caprio and Levine, 2002).

A further issue is that the interests of bank shareholders may oppose those of governmental regulators, who have their own agendas, which may not necessarily coincide with maximising bank value (Boot and Thakor, 1993). Shareholders may want managers to take more risk than is socially optimal, whereas regulators have a preference for managers to take substantially less risk due to their concerns about system-wide financial stability. Shareholders could motivate such risk-taking using incentive-compatible compensation schemes. However, from the regulators point of view, managers' compensation schemes should be structured so as to discourage banks from becoming too risky. For example, regulators could, through directives or moral suasion, restrict the issue of option grants to bank managers. Alternatively, regulators could vary capital requirements depending on the extent to which compensation policies encourage risk-taking (Caprio and Levine, 2002, p.22).

Some economists argue that competition in the product or service market may act as a substitute for corporate governance mechanisms (Allen and Gale, 2000). The basic argument is that firms with inferior and expropriating management will be forced out of the market by firms

possessing non-expropriating managers due to sheer competitive pressure. However the banking industry, possibly due to its information-intensive nature, may be a lot less competitive than other business sectors (Caprio and Levine, 2002). Therefore this lack of competitive pressure as well as the special nature of banking suggests that banks may need stronger corporate governance mechanisms than other firms.

### **3. Deregulation of Banks in Developing Economies**

In the section above we argued that the special nature of banking might require government-provided deposit insurance in order to protect depositors. Concomitantly, in order to ameliorate the associated moral hazard problem, we suggested that banks might need regulated. However, over the last two decades or so, many governments around the world have moved away from using these economic regulations towards using prudential regulation as part of their reform process in the financial sector. Prudential regulation involves banks having to hold capital proportional to their risk-taking, early warning systems, bank resolution schemes and banks being examined on an on-site and off-site basis by banking supervisors. The main objective of prudential regulation is to safeguard the stability of the financial system and to protect deposits. However, the prudential reforms already implemented in developing countries have not been effective in preventing banking crises, and a question remains as to how prudential systems can be strengthened to make them more effective (Brownbridge, 2002).

The ability of developing economies to strengthen their prudential supervision is questionable for several reasons. Firstly, it is accepted that banks in developing economies should have substantially higher capital requirements than banks in developed economies. However, many banks in developing economies find it very costly to raise even small amounts of capital. Secondly, there are not enough well trained supervisors in developing economies to examine banks. Thirdly, supervisory bodies in developing economies typically lack political independence, which may undermine their ability to coerce banks to comply with prudential requirements and impose suitable penalties. Fourthly, prudential supervision completely relies on accurate and timely accounting information. However, in many developing economies, accounting rules, if they exist at all, are flexible, and typically, there is a paucity of information disclosure requirements. Therefore, if a developing economy liberalises without sufficiently strengthening its prudential supervisory system, bank managers will find it easier to expropriate depositors and deposit insurance providers.

A prudential approach to regulation will typically result in banks in developing economies having to raise equity in order to comply with capital adequacy norms. Consequently, prior to developing economies deregulating their banking systems, much attention will need to be paid to the speedy implementation of robust corporate governance mechanisms in order to protect shareholders. However, in developing economies, the introduction of

sound corporate governance principles into banking has been partially hampered by poor legal protection, weak information disclosure requirements and dominant owners (Arun and Turner, 2002d). Furthermore, in many developing countries, the private banking sector is not enthusiastic to introduce corporate governance principles. For example, in India, this problem can be summarised in the corporate sector as the privileging of the interests of one group over all other interests in a company (Banaji and Mody, 2001).

#### **4. The Political Economy of Bank Corporate Governance in Developing countries**

In many developing economies, the issue of bank corporate governance is complicated by extensive political intervention in the operation of the banking system. The pertinent issues that we briefly want to examine are government ownership of banks, distributional cartels, and restrictions on foreign bank entry.

Government ownership of banks is a common feature in many developing economies (La Porta et al, 2002). The reasons for such ownership may include solving the severe informational problems inherent in developing financial systems, aiding the development process or supporting vested interests and distributional cartels (Arun and Turner, 2002a). With a government-owned bank, the severity of the conflict between depositors and managers very much depends upon the credibility of the government.

However, given a credible government and political stability, there will be little conflict as the government ultimately guarantees deposits.

Nevertheless, in economies where there is extensive government ownership of banks, the main corporate governance problem is the conflict between the government / taxpayers (as owners) and the managers / bureaucrats who control the bank. The bureaucrats who control government-owned banks may have many different incentives that are not aligned with those of taxpayers. These bureaucrats may maximise a multivariate function which includes, amongst other things, consumption of prerequisites, leisure time and staff numbers. Also, bureaucrats may seek to advance their political careers, by catering to special interest groups, such as trade unions (Shleifer and Vishny, 1997, p.768). Furthermore, bureaucrats are by nature risk averse, and will therefore undertake less risk than is optimal from the taxpayers' point of view. In order to partially mitigate such opportunism, bureaucrats may be given little autonomy. In particular, banks may face regulations requiring them to allocate certain proportions of their assets to government securities and various sectors, such as agriculture and SMEs, that are deemed important from a societal viewpoint. However, in the absence of market-provided incentives, the managers of government-owned banks may still be able to engage in opportunism at the taxpayers' expense through shirking or empire building. Perhaps this is why the Basel Committee on Banking Supervision (1999, p.4) argues that "government ownership of a bank has the potential to alter the strategies and objectives of the bank as well as the internal structure of governance. Consequently, the

general principles of sound corporate governance are also beneficial to government-owned banks”.

The inefficiencies associated with government-owned banks, especially those emanating from a lack of adequate managerial incentives have led developing economy governments (under some pressure from international agencies) to begin divesting their ownership stakes (Arun and Turner, 2002a). The divestment of government-owned banks raises several corporate governance issues. If banks are completely privatised then there must be adequate deposit insurance schemes and supervisory arrangements established in order to protect depositors and prevent a financial crash (Arun and Turner, 2002b,c). On the other hand, if divestment is partial, then there may be opportunities for the government as the dominant shareholder to expropriate minority shareholders by using banks to aid fiscal problems or support certain distributional cartels. Therefore, the question in this case, is whether or not the government can credibly commit that it won't expropriate private capital owners. For instance, in India, the partial divestment of public sector banks has not brought about any significant changes in the quality of corporate governance mechanisms (Arun and Turner, 2002b). Despite a decade of financial reforms in India, the Government has still a major role in appointing members to bank boards. Furthermore, although the reforms have given the public sector banks greater autonomy in deciding the areas of business strategy such as opening branches and introduction of new products (Muniappan, 2002), bank boards have little overall autonomy, as they are still to follow the directives issued

by the government and central bank (AGCG, 2001, pp.10, 30-31, 33). One way it could do this is to reduce its control over managers and give them much more autonomy to act in the interests of all stakeholders with the caveat that suitable supervisory powers and authority be given to the appropriate regulatory authorities.

A further issue, which complicates the corporate governance of banks in developing economies, are the activities of 'distributional cartels' (Oman, 2001, p.20). These cartels consist of corporate insiders who have very close links with or partially constitute the governing elite. The existence of such cartels will undermine the credibility of investor legal protection and may also prevent reform of the banking system.<sup>3</sup> Unsurprisingly, good political governance can be considered as a prerequisite for good corporate governance (Oman, 2001, p.31).

In many transition economies, it has been observed that competition is more important than change in ownership, and, could provide managers with appropriate disciplinary mechanisms (Stiglitz, 1999). Above, it was suggested that competition might act as a substitute for corporate governance. However, banking in developing economies typically has government-imposed barriers to entry, especially on foreign banks. Some notable exceptions are Botswana, Gambia, Lesotho, Rwanda and Zambia (Barth et al, 2001). Nevertheless, in contrast, foreign banks have made little inroads into the developing economies of Asia.

Claessens et al (2000) suggest that the entrance of foreign banks actually increases the efficiency of the developing economy banking sectors. One possible rationalisation of this finding is that foreign banks bring with them new management techniques, corporate governance mechanisms and information technologies which domestic banks have to adopt in order to effectively compete with their foreign rivals (Peek and Rosengren, 2000, p.46). A further benefit from permitting foreign bank entry is that it may result in a more stable banking system. Notably, empirical studies by Demirguc-Kunt (1998) and Levine (1999) suggest that the presence of foreign banks reduces the likelihood of banking crises and may result in banks becoming more prudentially sound.

Although foreign banks may have a positive impact on banking system stability and efficiency, developing economy governments may be reluctant to permit their entry because they lose some ability to influence the economy. Indeed, foreign banks may be less sensitive to indirect government requests and pressures than domestic banks (Stiglitz, 1994, p49). The executives of domestic banks may have connections with the country's governing elite and may be seeking business or political favours in return for acquiescing with government requests. Also, the threat of closure is of larger consequence to a domestic bank than a foreign bank with an international presence. The ability of foreign banks to ignore government requests may give them a further competitive advantage. However, there is an argument that the foreign bank penetration could



undermine the ability of the governments to use the banking system to achieve social and economic objectives.

#### **4. Conclusions and Policy Implications**

This paper has argued that the special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in developing economies such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank capital and the presence of distributional cartels.

In order to deal with these problems, we suggest that developing economies need to adopt the following measures. Firstly, liberalisation policies need to be gradual, and should be dependent upon improvements in prudential regulation. Secondly, developing economies need to expend resources enhancing the quality of their financial reporting systems, as well as the quantity and quality of bank supervisors. Thirdly, given that bank capital plays such an important role in prudential regulatory systems, it may be necessary to improve investor protection laws, increase financial disclosure and impose fiduciary duties upon bank directors so that banks can raise the equity capital required for regulatory purposes. A further reason as to why this policy needs implemented is the growing recognition that the corporate

governance of banks has an important role to play in assisting supervisory institutions to perform their tasks, allowing supervisors to have a working relationship with bank management, rather than adversarial one (BCBS, 1999).

We have suggested that the corporate governance of banks in developing economies is severely affected by political considerations. Firstly, given the trend towards privatisation of government-owned banks in developing economies, there is a need for the managers of such banks to be granted autonomy and be gradually introduced to the corporate governance practices of the private sector prior to divestment. Secondly, where there has only been partial divestment and governments have not relinquished any control to other shareholders, it may prove very difficult to divest further ownership stakes unless corporate governance is strengthened. Finally, given that limited entry of foreign banks may lead to increased competition, which in turn encourages domestic banks to emulate the corporate governance practices of their foreign competitors, we suggest that developing economies partially open up their banking sector to foreign banks.

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## Notes

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<sup>1</sup> According to Berle and Means (1932), the separation of ownership from control had occurred in the United States by the late 1920s.

<sup>2</sup> Various suggestions have been made in the literature as to how this basic principal-agent problem can be ameliorated (Abowd and Kaplan, 1999; Andrade et al, 2001; Hermalin and Weisbach, 2001; Jensen and Meckling, 1976; Jensen and Murphy, 1990; La Porta et al, 1998, 1999, 2000; Shleifer and Vishny, 1986; 1997).

<sup>3</sup> Mayer and Sussman (2001, p.460) make the pertinent point that regulation and the legal system are endogenous and are an outcome of the political bargaining process.