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ROLE OF CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS: A REVIEW

Dr. Pragya Dheer*

ABSTRACT

After the financial crisis taken place in 2008, a substantial part of blame regarding failure of banking system / financial system in crisis has been put on corporate governance. Weak and ineffective corporate governance mechanisms, rules, regulations and guidelines for banks and other financial institutions are considered as the major factors in occurrence of the financial crisis. Consequently, both regulations and supervisions are proposed to enhance corporate governance in relation to financial institutions and as a substitute for the same area where governance failed to supervise and control the financial institutions which is the evidence of failure. Therefore, deep changes in these areas are seem relevant and necessity to reinforce the financial sector stability. Thus, this paper aims at review the role of corporate governance in financial institutions such as banks, insurance companies etc. As governance framework is made to encourage the efficient use of available resources and also it is equally required for accountability of the used resources. The aim of corporate governance is just to align corporate governance as nearly as possible, in the interest of individuals, corporations and society.

KEYWORDS: *Corporate Governance, Financial Institutions, Risk Management.*

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Introduction

Especially for financial institutions, corporate governance is a set of standards and principles used to create a system for checking and balancing the management of banks, financial intermediaries or financial system overall. It guides the path through which financial institutions are directed and controlled either ordinarily through set standards decided by the board of directors or by the senior management.

The Organization for Economic Cooperation and Development (OECD) described the Corporate Governance as "the system by which business corporations are directed and controlled. Its structure specifies the distribution of rights and responsibilities among the different participants in a cooperation such as the board, managers, shareholders and other stakeholders and spell out the rules and procedures for making decisions on a corporate affairs. By doing so, it provides the structure through which the company's objectives are set, and the means of attaining those objectives and monitoring performances." Further in 1999, Organization for Economic Cooperation and Development (OECD) had published the *Principles of Corporate Governance*, which focuses on publically traded companies, both financial as well as non – financial. The principles were subsequently updated and available in 2015 edition, which had been issued under the auspices of G20/OECD[1].

Literature Related

For the evaluation of Corporate Governance, Kavalir, (2005) stated that the corporate governance may be described in several quotes such as: a system through which companies are managed and controlled. For the same, the statutory bodies are responsible for their various affairs done in relation to the corporate management. Aforesaid, responsibility meant the setting of companies strategic goals, keeping in view the realization of goals, supervision of management and informing shareholders about their performances.

According to Demb and Neubauer, 1992, Corporate Governance is a process through which companies make discussion with their shareholders about their rights and requests.

* Assistant Professor, Department of Commerce and Management, University of Kota, M.B.S Marg, Near Kabir Circle, Kota, Rajasthan, India.

Whereas, According to Klirova, 2001, Corporate Governance is treated as the key element which can reach to economic efficiencies and a growth which justify increase in the investor's trust. Similarly, corporate governance encompasses a broad range of problems arising from the relationship between the corporate management, administrative authorities, shareholders and other stakeholders.

For further development, Organization for Economic Cooperation and Development (OECD) had published *Principles of Corporate Governance* in 1999 which has been then taken up by Basel Committee on Banking Supervision (BCBS) for drafting its own guidelines on principles of corporate governance for banks. Through these laid principles, Basel Committee on Banking Supervision (BCBS) directs and assist supervisors in promotion of sound corporate governance practices, with the belief that "by a sound corporate governance, bank supervisors can create a participative working relationship with bank management, rather an adversarial one." Further in 2015 edition, aforesaid guidelines underlined "effective implementation of sound corporate governance must be requires for relevant, legal, regulatory and institutional foundation" and as a result it encourages supervisors "to increase their awareness regarding legal and institutional impediments of a sound corporate governance, and to take remedial steps to foster effective foundationof corporate governance where it is in their legal authority." Thus, the main goal of 2015 Basel Committee on Banking Supervision (BCBS) guidelines is to emphasize the role of risk governance in banks. Thereforefor the same, objectives must be "to explicitly reinforce the collective oversight and risk governance responsibilities of the board" and "to emphasize key components of risk governance such as risk culture, risk appetite and their relationship to a bank's risk capacity.

About Financial Institutions

In an economy adequate funds are required to carry out various economic activities. The availability of funds is presupposed to be a strong financial system. The financial system provides a base for economic development of a country because a business firm can collect funds for its capital on an approved cost of such economic funds. In order to accelerate the rate of economic growth, the availability of funds requires the creation of financial infrastructure in the form of banking and financial institutions. The flow of funds in financial institution forms the part of financial markets. Financial Institutions are enterprises that provide financial services. They perform the following functions such as transformation of financial assets, broker – dealer services, assets management. In the lieu of the above mentioned functions, financial institutions are described in 3 types which are identified as: financial intermediaries, investment firms and asset managers[2].

Financial Institutions are theinstitutions which are helpful in purchase and sale of finanacial documents and help in mobilizing the savings along with the facilityof allocation of funds in an efficient manner. Such institutions in financial markets are generally of two types such as Depository and Non – Depository Institutions. Depository institutions comprises of commercial banks, savings and credit organization, mutual saving bank, co-operative credit institutions etc. Whereas, Non – Depository Institutions are functioning in financial market as financial intermediaries namely Developmental Financial Institutions (DFI) and Non – Banking Financial Companies (NBFC's) as well as Housing Finance Companies (HFC's) are the major institutional purveyors of credit.

Thus, financial intermediary institutions are those which act as a link between the creditors and borrowers. Additional savings is resulted with the creation of employment and income in the economy. These additional savings are again included in the investment process through these financial institutions. In other words, we can say that financial institutions are engaged in two types of functions. They bring savers in contact with the borrowers on the one hand and to satisfy portfolio preferences of individuals and firms on the other hand. New securities are issued to make available the funds for purchasing real estate, plants and machinery. Meeting business requirements is the main function of the financial intermediary institutions. Thus, financial institutions act as a businessman in sales and purchases of securities in the market, whereas, Financial Markets is a mechanism enabling participants to deal in financial claims. Money market and Capital market are the organized financial markets in India. Many market is for short term securities while capital market is for long term securities. Primary market deals in new issues, the secondary market is meant for trading in outstanding or existing securities. Financial market facilitates the transaction of financial assets in the economy. Bonds, government securities, shares, debentures etc. are bought and sold in these financial markets. The classification of a financial market is done on the basis of the purchase and sale of documents. It constitutes loan market, share market and financial service markets. Financial funds are raised from loan market while permanent reserves are collected through share market. The market is also classified on the basis of period which may be short term, medium term and long term markets. Commission agents, banks, non – banking financial institutions and the Reserve Bank of India are engaged in purchase and sale activities in financial markets.

Risk Related to Financial Institutions

The Basel Corporate Governance Principles specifies and identify the risks streaming from the incorrect selling of financial products to individual and business clients; the disobey of national and international tax rules and regulations, anti-money laundering law, anti-terrorism law, economic sanctions, etc. including the manipulation of financial markets, e.g. the manipulation of Libor rates and foreign exchange rates[3]. Financial institutions in the business bears risk and were able to manage them. In doing so, they have to face the following 'idiosyncratic' risks[4]:

- **Credit Risk:** it is a risk that financial institution has to bear if the holder of financial instrument fails to fulfil its obligation on the due date or at any time thereafter;
- **Settlement Risk:** It is a risk which is used for the settlement of trade or obligation along with the failure in transfer of money which takes place as expected. It may be in the form of credit risk and liquidity risk.
- **Counterparty Risk:** It is the risk that a counterparty of a trade bears if he fails to satisfy its obligations;
- **Liquidity Risk:** It is an additional part of settlement risk, it appears in two forms: market liquidityrisk, i.e. the risk in which financial institution is unable to transact in a financial instrument at a pricenear to its market value; and funding liquidity risk, i.e. risk in which financial institution show its incapability to getthe required funds which areneeded to satisfy its obligations;
- **Market Risk:** It is a risk that arises due to the adverse movement in the market price of an owned asset of a financial institution;
- **Operational Risk:** It is a risk that arises out of loss resulting from inadequate or failed internal processes, people and systems, or events[5]. It includes legal risk, i.e. the risk of loss due to failure in complying with laws, prudent ethical standards and contractual obligations.

However, due to the great financial crisis, the importance of systematic risk in financial institutions is distinguished as "idiosyncratic risk". Systematic risk such as an economic shock or institutional failure, chain of bad economic consequences, chain of failures of financial institutions and / or market are some common factors which may be analysed as triggering events in systematic risk.[6]Whereas, an idiosyncratic shock will affect only a single institution or asset.Systemic risk in this matter, focuses on the danger of collapse of entire financial system, causing a major downturn in the real economy. Indeed, the consequences of a systemic financial crisis are more devastating than those of other economic crises because the role of that finance plays a major part in the economy.[7]

Corporate Governance Legal Guidelines

The *OECD Guidelines on Insurer Governance* follow a path similar to that of the BCBS Guidelines which were "designed in light for achieving objective of an insurance undertaking, to provide benefits to the insured in accordance with the contracts concluded with them, and satisfy its shareholders (member-policy holders in the case of mutual insurers)".[8]Their rationale is explained accordingly: "insurers are expected to have sound governance practices and effective risk management so that they will be in a position to provide promised benefits to their policy holders (relevant beneficiaries) and thus fulfil their insurance function in the economy"[9]

The Basel Committee's *Corporate Governance Principles for Banks* clears the overarching principle of proportionality by specifying that their implementation "should be commensurate with the size, complexity, structure, economic significance, risk profile and business model of the bank and the group (if any) to which it belongs. The principle aforesaid meant that making reasonable adjustments where appropriate for banks with lower risk profiles, and considered as an alert to the higher risks that may accompany more complex and publicly listed institutions."

Moreover, banks those are qualified as systemically important financial institutions (SIFIs) are "expected to have best corporate governance structure and practices commensurate with their roles and potential impact on national and global financial stability". Indeed, SIFIs' distress or disorderly failure can be a cause of significant disruption to the financial system and economic activities, due to their size, complexity and systemic interconnectedness[10]. The objective of this framework is to address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as big failure. So for the intensive and effective supervision of all SIFIs it is required to have stronger supervisory mandates, resources and powers, along with higher supervisory risk management functions, data aggregation capabilities, risk governance and internal controls.[11]

Therefore, in other words we can sayCorporategovernance may be different in different banks, on the basis oftheir standards (typical for other companies), which is due to several issues such as: [12]

- Banks are subject to special regulations and supervision either by state agencies or central agencies for monitoring activities and supervision of banks.
- Bankruptcy in a bank which rises due to social costs;
- Regulations and measurement of safety withnet substantial change in the behaviour of owners,managers and customers of the banks;
- fiduciary relationships rising from additionalrelationships and agency costs;
- problems between principal and agent;

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

Thus, in the case of banks, corporate governance is the need to perceiveit as a requirement of suchconduct in an institution, which would force the management to protect the interests of allstakeholders and ensure responsible behaviour and attitudes towards them (Tirole, 2001).

Therefore, Corporate Governance is a way of business and affairs of the bank done by the management and the board, which are affecting how they (BCBS, 2006, February):

- defining the objectives and goals;
- leading current bank activities;
- fulfilling the obligation or accountability towards shareholders and take into account the interests of stakeholders;
- applying the requirement to operate safely and also to ensure a good financial position and compliance with applicable regulations;
- protect the interests of depositors, clients and creditors.

The only shortcomings in the governance of large financial groups are indicated that there may be indirectly systemic risks. Regulators and financial supervisors takes action for the same to ensure anindividual bank's stability. Whereas, in the case of important banks this would result in thepursuit of overall financial stability. The main issues of corporate governance matters withspecific systemic impact are: the "gatekeepers" (especially auditors and credit rating agencies),corporate values and code of conduct of specific banks, risk management and internal governance ofbanks managerial incentives, accounting (valuation) rules(E. Wymeersch, 2008, October).

Conclusions

The confidence of the public in a bank and the entire banking system is mandatory for a proper functioning of the financial system and economy. Effective corporate governance practices are necessary to gain and maintain this confidence (BCBS 2006, February). As the recent Edelman "trust barometer" study shows, banks and financial services are the two least trusted industry sectors (for the second year in a row)[13].

Trust is a basic prerequisite for a proper functioning of banks, therefore it is necessary to carry out fundamental reforms that will bring inner harmony and allow the recovery of the public trust. Therefore, an in-depth analysis of the recent crisis causes should be done. Particularly considering that the rules of proper conduct of banking business exist and are being implemented, but it is mainly the deficiencies in corporate governance which are to blame for the recent financial crisis[14].

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