New Instruments In Corporate Governance Of EU Bank Groups

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NEW INSTRUMENTS IN CORPORATE GOVERNANCE OF EU BANK GROUPS*

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Summary

The corporate governance practices of EU bank group were based on the principle of self-regulation. The negative effects of adoptation of the principle were on stakeholders account – deposit insurance funds, government loans, depositors, and taxpayers.

The international financial crisis gives reasons for new institutional framework. The taken measures on pan-European level defined new role for traditional actors in which key actors are shareholders and regulators. The new instruments in modern corporate governance are decrease of corporate structure complexity and isolation of different services in separate entities.

Key words: corporate governance, bank groups

JEL code: G34, G21

Policies for free movement of capital and competitiveness determine the profile of the EU banking system at the beginning of the XXI century. They are used in national programs for economic growth through active participation of banks. The supervisory authorities allows restructuring of banking groups, incl. removal of risk activities in the new member states from Eastern Europe, creating a complex organizational structures and offering new financial services.

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The liberalization of financial markets creates complex and interdependent financial system[1]. Individual national economies have become dependent on other countries and create an environment in which financial difficulties can be easily transferred and threaten the entire financial system.

Transnational banking groups have built complex organizational structures outside national borders, but the management and control stayed at home state. The pluralistic structure of the EU banking system, the diverse nature of the commitments on corporate governance and the different business models represented strength of the banking sector in the EU, but also a factor that hinders future integration and the emergence of a single pan-European banking model[2].

The new reality considers corporate governance to a qualitatively new level. The report „de Larosière“ (2009) to the European Commission describes corporate governance practices as „one of the most important shortcomings of the current crisis“[3].

The position represented by the Steering Group of the OECD (2009) identified four weaknesses in corporate governance contributed to the financial crisis: remuneration of executive directors, risk management, practices of the board of directors/management board and implementation of shareholder rights[4]. Admitted shortcomings are the actions of politicians and companies in the implementation of the OECD Principles of Corporate Governance.

As a result of the economic crisis is formed opinion about greater use of regulation instead of regulatory „codes and standards“[5]. The crisis has opened an old debate about the

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[1] Pistor, K. Governing Interdependent Financial Systems: Lessons from the Vienna Initiative. The Center for Law и Economic Studies, Columbia University School of Law. Working Paper No. 396, 2011.

[2] Arnaboldi, F., B. Casu. Corporate Governance in European Banking. Working paper series WP 01/11, City University London, 2011.

[3] Green Paper. Corporate governance in financial institutions and remuneration policies. 2010. COM(2010) 284.

[4] Sun, W., J. Stewart, D. Pollard. Corporate Governance and the Global Financial Crisis - International Perspectives. Cambridge University Press. 2011, p. 55.

[5] OECD. Corporate governance and the financial crises. Steering group on Corporate governance. Paris, 2010.

costs and benefits of regulation as an opponent of market mechanisms. In some cases, supervisors have been subject to potentially, contradictory aims and interests, such as protecting investors and maintaining the security of banking institutions.

Measures to coordinate the supervision of credit institutions should be applied to all credit institutions in order to protect savings and to create equal conditions of competition between them[6]. New supervisory policies are geared to advantage of the public interest before the bank interests[7]. National reforms on corporate governance are aimed at transforming from „stability“ to „stakeholders“[8].

Modern corporate governance policies cover its actors and instruments:

- Shareholders (rights and responsibilities);
- Management boards (remuneration of managers);
- Auditors (exchange of information with the supervisory authorities);
- Regulators (regulation rather than regulatory "codes and standards" and convergence of supervisory practices);
- Tools (reducing the complexity of organizational structures and the possibility of transmission of financial crises).

Dynamics of EU policies to improve practices in corporate governance for the period 2006-2013 includes: shareholders (active exercise of rights and responsibilities), managers (reducing „risk appetite“ through policies on the remuneration), regulators (convergence of practices, including external auditors and new tools).

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[6] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.
[7] Motion for a European Parliament resolution on reforming the structure of the EU banking sector (2013/2021(INI)).
[8] United Nations Conference on Trade and Development. Corporate Governance in the Wake of the Financial Crisis. Selected international views. 2010, p. iii.

Tool 1: *Reducing the complexity and interconnectedness of group structures*

The motives for the efficient use of capital and liquidity, tax benefits, supervisory requirements, legal requirements of previous corporate structure of a merger, led to complex corporate ownership structures in banking groups. Group structures and intra-group relations are generated from interest on servicing corporate objectives: getting high ratings and meet the requirements of the supervisory authority.

According to the Basel Committee reduction of the complexity and interconnectedness of group structures and activities is a major tool for improving practices in corporate governance[9]. Solutions to overcome the crisis are further hampered and expensive by the presence of large international groups with corporate structures operating in several jurisdictions and their internal and external exposure and relationships. Measures on simplification of group structures will contribute to an acceptable solution in the event of bankruptcy regardless of the financial sector and the state of business. Last but not least, the effective reduction of the complexity of group structures will contribute to more rapid recovery of banks and lending to the real economy, which are vital for economic growth[10].

Regardless of the achieved economic integration, the opportunities for intervention by supervisors remained within national boundaries. The series of remedial measures at national level and a wave of uncoordinated bankruptcies put on the agenda further challenges to EU.

In modern conditions the competent authorities received additional powers that allow them to require changes to business structures of banking groups and restrict banking activities. An additional tool is early intervention by supervisors, including the requirement for the transfer of some activities, the appointment of an emergency manager and stop the payment of dividends.

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[9] Basel Committee on Banking Supervision. Report and Recommendations of the Cross-border Bank Resolution Group. BIS, 2010.

[10] Motion for a European Parliament resolution on reforming the structure of the EU banking sector (2013/2021(INI)).

Tool 2: *Reduce the likelihood of transmission of crisis*

Another tool in corporate governance is to reduce the likelihood of contagion between activities performed by banks. In actions in the EU Structural reforms prevail over nonstructural[11].

One reform in the EU provides commercial banks to separate the trade with their own funds in self-financed units. The recommendations of the expert group of Erkki Liikanen to the European Commission provide „fencing" (ring-fencing) of the operations of banks, including deposits from depositors and lending to small businesses from the other activities of banks. The „ring-fenced" legal person of the bank must have its own policy on corporate governance. The aim is to increase the security of banks by separating high-risk banking activities of daily banking and to prevent the transmission of „financial contagion" and protect creditors and depositors. For cross-border banks imposed restrictions on intra-group transactions aimed at protecting the „financial contagion" from the parent bank and withdrawal of capital[12].

The separation of activities as a tool to reduce the risks apply in the EU according to the recommendations of the report of the Liikanen (2011), in the UK - the Commission of Vickers (2011) and in the US – Volker's rule (2012). General between recommendations is the mandatory nature of the separation of commercial banking from investment banking[13].

Using this tool will help to strengthen the banking groups in several ways. First, it will encapsulate the banks to protect themselves from losses. Secondly, will allow banks subsidiaries to obtain local facilities for loans from the central bank and deposit insurance schemes. Third, reduced complexity and size of banking groups to make them more transparent to external stakeholders and easier decision-making, which in turn will improve risk management and market discipline. All these benefactors will reduce the exposure to taxpayers losses from the banking sector.

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[11] Maes, S. Structural Reform in the EU Banking Sector. IMF, 2013.
[12] Basel Committee on Banking Supervision. Report and Recommendations of the Cross-border Bank Resolution Group. BIS, 2010.

[13] Gambacorta, L., A. van Rixtel. Structural bank regulation initiatives: approaches and implications. BIS Working Papers No 412, 2013.

Conclusion

European policies for the reform of corporate governance are transformed by „competitiveness“ through „resistance“ to „stakeholders“. New tools in corporate governance led to desubsidiarization of banking groups in sectoral and territorial principle.

The objectives of the new instruments in the corporate governance of banking groups can be summarized as:

- maintain financial stability and confidence in banks, while avoiding the effect of contagion;

- reduce exposure to taxpayers losses from the banking sector and reduce moral hazard;

- reduce the costs of the national network security;

- facilitate the process of decision-making in future crisis;

- incentive for banks to participate in economic growth;

- coordination and overlapping of the objectives pursued by the various national authorities in situations of bankruptcy;

- elimination of the need for action at EU level for selecting the resolution authorities and procedures for bank stabilization.

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2. Basel Committee on Banking Supervision. Report and Recommendations of the Cross-border Bank Resolution Group. BIS, 2010.

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11. United Nations Conference on Trade and Development. Corporate Governance in the Wake of the Financial Crisis. Selected international views. 2010.