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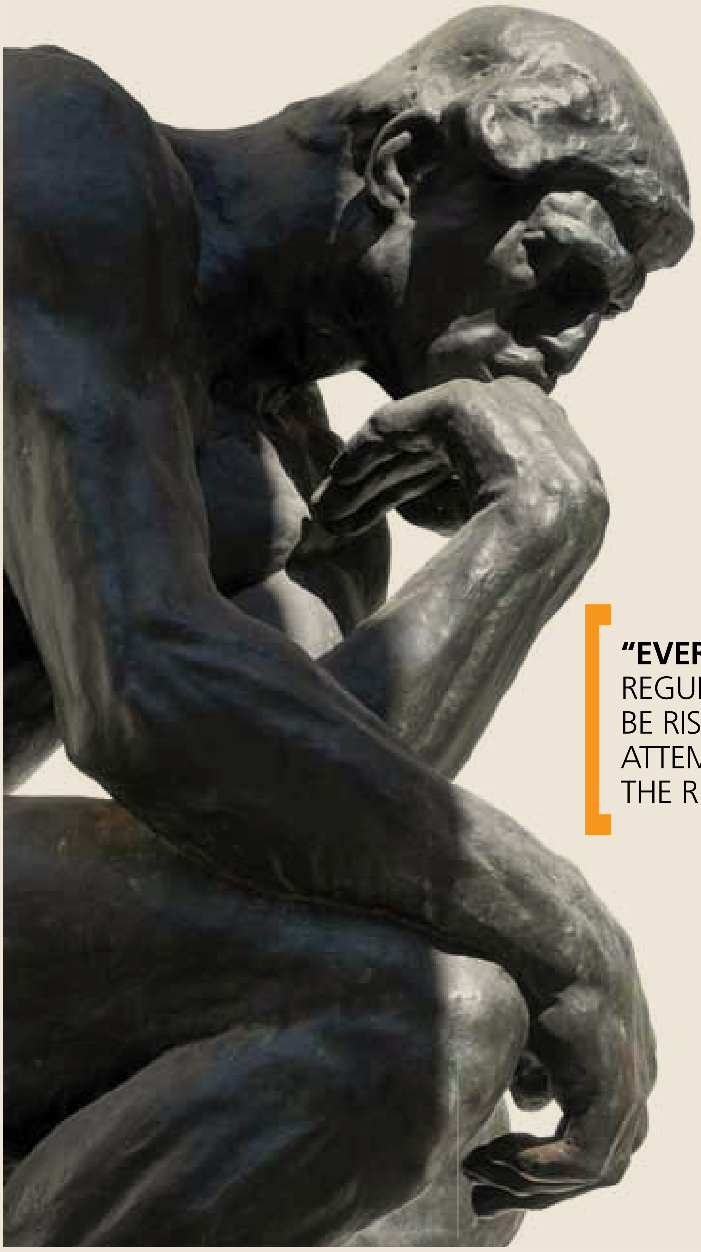
Regulators also have a **'duty of care'**

At September's annual conference of the Wolpertinger Club of university banking researchers in Valencia, Bangor University's Prof TED GARDENER explored the latest thinking about the post-crisis corporate governance of banks.



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The financial crisis that began in 2007 has prompted an enormous theoretical and policy debate about the post-crisis 'best' future corporate governance systems and business models for banks.

A perfect corporate governance system would provide managers with the right incentives to make value-maximising decisions for owners. It would ensure that cash was paid out to investors when the company is unable to generate positive Net Present Value investments. It would provide managers and employees with fair compensation, but would not allow excessive managerial and employee perks of any kind.

This view of corporate governance is consistent with the free market model, where investors ultimately determine the internal resource allocation decisions of firms: shareholders' wealth maximisation is the dominant corporate objective.

During the post-1970 era, deregulation moved global banking systems along this free market trajectory. Many banking and financial crises have not deflected this deregulation policy. The latest, most severe of these crises has prompted much re-thinking, but the discipline of the free market is still the preferred policy context in countries like the US and UK.

In the past ten years or so, corporate governance has become much more central in the debate on banking structures, strategy and regulation. The theory is that, so long as markets are provided with sufficient information, they will ultimately discipline and incentivise the required value-maximising behaviour.

> **"EVER TIGHTER, MORE** DETAILED REGULATIONS MAY ULTIMATELY BE RISK-PRODUCING AS BANKS ATTEMPT TO INNOVATE AROUND THE RULES."

The recent crisis has not interred this standard model in banking, but it has certainly raised some fundamental questions. And, in all the post-crisis studies, the emphasis, not surprisingly, has been on risk governance. Broadly speaking, two main schools of thought can be identified: a shareholder-dominant approach (typified by the 2009 UK Walker report), and a stakeholder-based one (typified by the 2010 Basel Committee and the EU approaches).

The debate has also addressed the fact that banks are different from non-banking firms: all banking systems rest ultimately on confidence. So long as bank depositors remain confident their bank can repay its deposits on any day, banks can borrow short and lend longer. This confidence preservation always has been the bedrock of fractional reserve banking.

A raft of special banking regulations – the central bank lender of last resort function, deposit insurance and 'too big to fail' regulatory interventions – all reflect the practical importance of this depositor and market confidence. The ‘costs’ of these banking-unique regulatory interventions (especially high in a crisis) are borne ultimately by government and taxpayers because of banks’ unique importance to economic stability and growth.

These necessary interventions carry with them certain privileges and responsibilities that all banks enjoy. They enable banks to operate with higher levels of leverage and risk assumption than would otherwise be possible in a completely free market. There has to be a price and a required level of professional responsibility assumed for these economic responsibilities and privileges.

In devising an effective, post-crisis system of corporate governance for banks, I believe there are three basic requirements:

1. The special role and unique economic position of banks must be recognised.
2. A system is needed that enables the free market model (deregulation) to work effectively and safely in disciplining the banking system and allocating resources most efficiently.
3. The most important ‘market failures’ associated with modern banking need to be recognised and addressed.’Market failures’ here refers to those regulatory interventions (like the central bank lender of last resort and ‘too big to fail’) that are atypical of banking and which necessarily interfere with the workings of the free market.

There are no easy solutions. Banking history appears to confirm that ever more regulations in key areas like risk, capital adequacy and liquidity are not the complete answer. So where does this lead? First, banks’ special nature means that the duty of care (so-called ‘fiduciary duties’ to key stakeholders) is wider for bank directors. It should encompass bank depositors, especially retail depositors who do not have the expertise (or incentive, given the implied ‘backstop’ role of the central bank and government) to assess banking risks.

In practice, bank directors must be fully cognisant of any decision that might impact badly on bank capital adequacy (solvency risk) and affect its ability to repay bank depositors.

By itself, though, this is not enough because bank regulators are also a key party in evaluating and ultimately determining capital adequacy. Their key role is in setting (at least broadly) the level of crisis scenario for which bank capital has ultimately to be adequate. The free market is not able (or incentivised) to do this. Even supervisors, with all the information they have, cannot precisely set banks’ exact downside risk needs – but they do have the final word on what level of bank risk cushioning is adequate.

So, it follows that senior bank supervisors should have fiduciary duties of care to banks and especially their customers in carrying out this important and unavoidable task. This leads to a kind of tripartite system of bank corporate governance. First, it requires fiduciary duties of bank directors and the senior management team to bank depositors. Second, it requires bank supervisors also to have fiduciary duties to bank depositors. Together, this system would subject banks, thirdly, to the shareholder-based model of corporate governance. The latter might work more effectively, reducing the probability of systemic shocks and contagion risk.

These are not ‘easy solutions’, without some challenging practical issues. Nor would they guarantee bank safety and prudence. But they would at least address the real problem of the ‘market failures’ which compromise an unaided free market solution to bank corporate governance. They would also surely put a premium on the professionalism demanded of supervisors, bank directors and senior managers.

References: Jean Dermine (2011), ‘Bank corporate governance beyond the global banking crisis’, INSEAD Working Paper 2011/33/FIN (Fontainebleau: INSEAD) Jonathan R. Macey and Maureen O’Hara (2003), ‘The corporate governance of banks’, FRBNY Economic Review, April.