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Banking on Governance? Conflicts of interest facing bank owners and supervisors

Chad Leechor

Banks fail with alarming frequency, resulting in large losses of taxpayer money. A key factor in the high failure rate is the flawed governance mechanism, which exacerbates the risks inherent in banking. Bankers control a lot of other people's money and have much discretion over the information they disclose. The temptation to engage in excessive risk taking is strong. Tightening banking supervision is seldom the solution. For their part, banking supervisors often face incentives at odds with those of taxpayers. At times they may prefer not to act to minimize taxpayer losses. These twin governance problems are further compounded by the common practice of disclosing banking information only to supervisors, not to markets. This Note explains the conflicts and proposes some solutions.

Modern banking has been characterized by frequent and widespread bank failures. Even advanced countries with sophisticated banking practices and supervision have periodically experienced large-scale banking distress. In the United States, for example, in a period of high interest rates in the early 1980s, a quarter of the savings and loan institutions failed. In the late 1980s the collapse of oil and real estate prices brought another wave of bank failures.

Virtually no country is immune to banking crises. According to recent studies, more than 130 countries have suffered major bank failures in the past two decades (see for example Caprio and Klingebiel 1999). In many cases the impact on the economy has been devastating. In Argentina, Estonia, and Poland more than half the banks failed in recent banking turmoil. The amount of public money needed to resuscitate the failed banks is often staggering (figure 1).

Banking is an inherently risky business. To begin with, banks have access to unusually high leverage. In nonbank firms a debt-equity ratio of 1 to 1 is considered high, and a ratio of 4 to 1—as seen

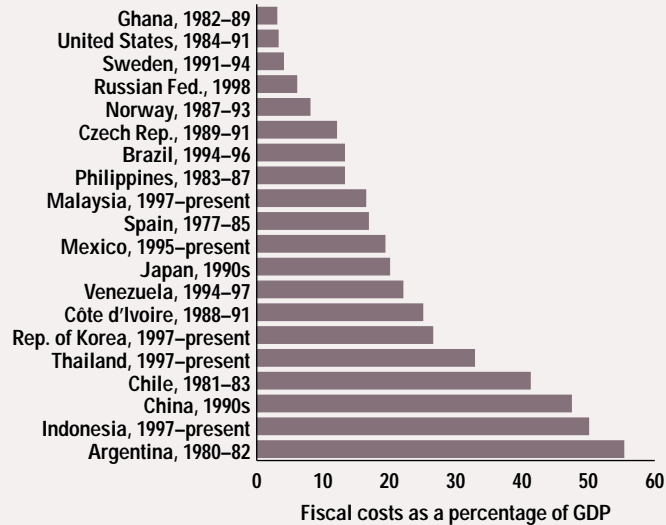
in East Asia—reckless. But in banking a debt-equity ratio of, say, 10 to 1 is considered prudent. Such leverage intensifies business risks. With fractional reserve requirements, banks may end up with no cash on hand to pay depositors. They can borrow from other banks or from the authorities, but only within limits. Bankers also face the risk of insolvency. If a bank loses a fifth of its asset value, it is technically insolvent and may be taken over by regulators. Wide swings in business conditions can wreak havoc on banks. Depressed cocoa prices, for example, may cause banking distress in Côte d'Ivoire and Ghana, while a fall in copper prices may hit Zambia and perhaps Chile.

This vulnerability is exacerbated by policy interventions. For example, public deposit guarantee limits depositors' runs on banks, but also encourages excessive risk taking by bankers (moral hazard). And it may cause depositors to disregard the quality of banks. The restrictions on bank branching or on foreign ownership as applied by some countries limit diversification and amplify the impact of cyclical and price fluctuations. Prudential rules of advanced countries also are often problematic. The risk of cross-border interbank





FIGURE 1 THE HIGH COST OF BANKING CRISES



Note: Costs for Ghana and Spain are shown as a percentage of GNP.
Source: Caprio and Klingebiel 1999.

lending, for example, is often understated in the metric of exposure (risk-weighted assets), leading to a cycle of excessive lending and destabilizing credit withdrawals.

These natural and man-made hazards are known or predictable. With good governance, a bank can be prudently managed to avoid the dangers. Then why are bank failures so frequent and widespread? It may have to do with the incentives and constraints of the decisionmakers in banks and supervisory agencies.

Heads I win, tails you lose

There is a conflict of interest between bankers (controlling shareholders and managers) and other stakeholders—outside investors, depositors, and taxpayers. It is often quite rational for bankers to take on risks that are not prudent from the perspective of the other stakeholders. Bankers can use devices that reduce their personal exposure. They also have an information advantage that can be used to conceal the risk exposure. In these circumstances bankers are often drawn to inefficient risk taking.

How a banker sees the risk is affected by the combination of high leverage and limited personal liability. Consider a project that has a 90 percent probability of making US\$10 and a 10 percent

probability of losing US\$100. Socially, this project is unattractive, with a negative expected value of US\$1. But if the banker's maximum loss is only US\$10 and the depositors are entitled to only US\$5 of interest, the project has an expected value of US\$4 to the banker. For some, it would appear rational to take the risk.

In developing countries especially, bankers can often reduce their risk exposure because weak banking rules and poor enforcement enable them to lend large amounts of money to themselves or to affiliates (related party lending). Such connected lending allows bankers to take risks with little or no exposure. This is the banker's escape—the flip side of a run on banks.

A bank's risk exposure is generally confidential. Detailed characteristics of individual assets (the borrower's identity and the status of each loan) are costly to monitor and verify. Many banks use historical cost accounting, which obscures their true financial condition. The use of new financial products, including derivatives and structured notes, has made risk exposure even more difficult to assess. Only bank management with a good information system and strong banking skills can effectively monitor portfolio quality.

In addition, bank management has much scope for discretion in valuing assets and in making provisions. Through small changes to individual loans, management can change the aggregate information it discloses by a wide margin. The use of independent auditors can help keep managers honest, but there are limits. Auditors generally certify financial statements on the basis of local standards, which may not be consistent with international standards. And auditors face a conflict of interest in their dual role as certified public accountants and bank consultants.

Who is watching the umpire?

The bank governance problem is often compounded by a conflict of interest between banking supervisors and depositors or taxpayers. Unlike shareholders, who have an equity expo-

sure, banking supervisors have no similar financial stake in public guarantee funds. Their compensation cannot be readily tied to performance through the tools of incentive contracts or equity ownership. Nor are banking supervisory agencies subject to the threat of takeover. As a result, there is little assurance that banking supervisors will use their best efforts in the interest of depositors and taxpayers. The widespread failures of public deposit guarantee funds stand in stark contrast to the well-governed—and profitable—business of private sureties, which provide credit guarantee on a commercial basis.

When confronted with banking trouble, supervisors may find it difficult to proceed if the bank is too big to fail or powerful politicians are trying to protect the banker. They may be reluctant to disclose the bad news, especially if the problem should have been discovered earlier. And supervisors may often find that friendly relations with bankers serve their long-term interests better than a strictly arm's-length relationship.

Banking supervisors have much discretion—for example, with regard to the definition of insolvency or the valuation of assets. A bank that is insolvent by accepted accounting standards may not be by the supervisors' rules. Supervisors may not recognize changes in the market value of assets or do so on a timely basis. And if it serves their interests, supervisors might delay the necessary regulatory action.

In the business of banking, time is literally money. Delayed corrective actions typically mean larger losses down the road. Troubled banks generally respond to losses by taking on more speculative investments in the hope of making up for them. But this “desperation” risk taking often only magnifies the losses.

These strategic official behaviors are not theoretical possibilities. Court documents and legislative records show that official delay has allowed many troubled banks to gamble with depositors' money. In the United States, for example, banking supervisors contributed to the

collapse of many public guarantee funds, including the Federal Savings and Loan Insurance Corporation in 1989 and state funds (Kane 1992). In these cases the supervisors involved had foreknowledge of the trouble, delayed corrective actions, and helped in the cover-up. Strategic behavior by supervisory officials is not confined to any particular country. In the 1990s financial scandals involving public officials have been uncovered in such countries as France, Mexico, and Russia and in many East Asian countries.

Three wishes for the genie

Good governance in banking relies on three key building blocks: *proper incentives*, *adequate transparency*, and *clear accountability*. Putting these building blocks into place may require unconventional reforms.

Aligning incentives

It is crucial that bank insiders have a significant equity stake in the banking business. But upholding this role is very difficult. Banks' accounting policies need to reflect market risks and borrowers' credit risks. Bank directors need to be accountable. Connected lending and ownership of banks by commercial interests need to be prohibited. Also helpful is expanding the scope for market insight, for example, through market-based disclosure (see below) and by rolling back public deposit insurance.

Essential, too, is to protect the interests of minority shareholders, especially among banks that are closely held. In particular, the duty of loyalty should be imposed on banks' controlling shareholders, who also serve as bank directors and executives (Leechor 1999). The presence of independent directors and the use of audit committees can also deter insider abuse.

The interests of the banking supervisors should be aligned with those of the taxpayers. As long as public deposit guarantee is provided, the rewards of the civil servants who manage the guarantee fund must be linked in some way to



the underwriting results. But this is not easy. Bringing in private sureties as business partners of the public guarantee fund is a possible alternative. The sureties would take the lead in pricing and underwriting the risks, with the public funds serving as coinsurers.

Ensuring transparency

The coverage and standards of banks' disclosure generally leave too much scope for discretion. Banks should be required to disclose not only their financial statements, but also their capital adequacy ratio, peak exposure concentration, lending to related parties, members of the board, and any conflicts of interest (Nicholl 1996). The disclosure should follow marked-to-market procedures, which reflect the effects of exchange rates, interest rates, and commodity prices. And bank directors should be required to attest that their disclosures are not false or misleading.

Another problem is that bankers are often required to give essential banking information only to the authorities, not to the market. This practice places undue reliance on banking supervisors. In a break from conventional practice, Chile and New Zealand have started moving toward market-based disclosure. Their banks make full public disclosure on a quarterly basis to market participants (depositors, their agents, and outside shareholders). This disclosure requirement gives bankers an incentive to be prudent.

Banking supervisors should also be more transparent. They should be required to disclose regulatory opinions on official forbearance or corrective actions. Where public deposit guarantee is used, they should disclose the risk exposure of guarantee funds, along with the standards for measuring the exposure. And the supervisors should be required to attest that their disclosures are not false or misleading.

Clarifying accountability

Along with better disclosure, competition in the banking business can make bankers more

accountable. Banks would have to rely more on investment merits, including good governance and creditworthiness, to attract funding. In addition, adequate sanctions against abusive practices are essential. For bank insiders, sanctions should include unlimited liability, particularly for a breach of disclosure rules. And when fraud is involved, criminal sanctions must be an option. Minority shareholders and taxpayers should have access to judicial remedies against insider abuse.

The performance of banking supervisors improves when they have clearly defined performance criteria and a governing body accountable to the taxpayers. The supervisors should set targets for the risk exposure of public funds, explain any deviations from the targets, and provide a clear plan of corrective actions. They should also face significant sanctions for breach of duty, including criminal sanctions for participation in fraud. But such rules are not easy to enforce. Independent and aggressive media can play a critical role. In addition, a government ethics office can help in investigating official misconduct.

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*Chad Leechor (cleechor@worldbank.org),
Private Sector Development Department,
Business Environment Unit*

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