

Everything about the financial system. Corporate governance - a vital element for bank stability

Analytical commentary

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Why do we need banks to be managed professionally and fairly?

Banking institutions play a crucial role by transferring resources from those who save money to those who invest, thus supporting the economic activity and helping the development of society. The way these institutions are managed is an important precondition for customer trust and depositor safety, elements that define the stability of the financial system. Therefore, banking activity is not a simple business, being characterized by complex relationships through which the bank is controlled, led and managed. All these relationships, embedded in a single mechanism, are called corporate governance, the purpose of which is to ensure the proper functioning of the bank both individually and as part of the overall banking system.

Corruption in lending activity, financial fraud or low bank efficiency could be the result of a weak and faulty corporate governance mechanism. An eloquent example in this regard are the frauds committed in the domestic banking system in 2014, and namely the governance gaps that allowed devaluing three banks and embezzling billions of lei by malicious stakeholders. Subsequent investigations have revealed a number of serious shortcomings in the management of several banks, including how decisions are made by the board of directors, the work of the executive body, or low transparency of shareholders. This affected the identification of relations with affiliated parties and the proper management of conflicts of interest. In general, after getting full control over Banca de Economii, Banca Sociala and Unibank, the management focused fully on using resources that did not belong to them for their own, for the group's or even political interests.

With a compromised corporate governance mechanism, the actions of the three banks' management affected and continue to affect the public and private environments. Supported by corruption, the depositor's money was stolen through the lending activity and was transferred to firms that proved to be the gateway to a well-established money-laundering mechanism. As a result, these loans created a huge gap that was covered with state budget money, money that could have been used for roads, schools, hospitals and other public investments. At the same time, the consequences of bank fraud have not completely dissipated and continue to affect the economic environment by the fact that, as a result of money laundering, some of the crime money might return into the country without a proven origin. These actions could further affect the population and economic balance, as the available money will be used for new acts of corruption, anti-competitive investments and other unlawful actions.

Though the 2014-2015 banking crisis highlighted many problems in the banking sector, the main responsibility belongs to key personnel and the way they managed the three banks. It is hence obvious that corporate governance in banks needs profound changes in order to strengthen the stability of the financial sector. This note presents the key aspects of the reform in this area, describing the roles, duties and responsibilities of management bodies and the governance principles to be followed by commercial banks, as an appropriate corporate governance could become a barrier hindering corruption and fraud in the lending process, as well as preventing the admission of people with suspicious intentions to key positions.

Corporate governance enhances the banks' efficiency, strengthens shareholders' profits and protects depositors

As proven by the results of the financial crisis, the failure of bank managers to follow the best practices in corporate governance can affect both the bank solvency and the stakeholders' interests¹. Thus both depositors and shareholders, on the one hand, and regulatory and supervisory authority, on the other hand, must be concerned about the robustness of corporate governance mechanisms. The depositors' interest stems from the natural desire to secure their savings entrusted to the bank and the banker's professionalism when investing and capitalizing on their money. Also, shareholders are interested in sustainable development of their business and maximizing profits in a prudent manner. On the other hand, the regulatory and supervisory authority has a public interest in maintaining the collective financial stability and the possibility to implement a proper monetary policy in order to sustainably support the Government's economic policies. Thus, due to the complexity of their work and the implications on a large number of stakeholders, the governance model for banks is much more complex and needs to be evaluated and supervised more carefully than for other businesses due to the following considerations:

- i. during their activity, banks use resources from the population and companies that must be repaid at a certain date (this defines banks as public interest entities);
- ii. bankruptcy of a bank generates economic, social and even political costs, which is not the case for other types of businesses;
- iii. bankruptcy of a bank can affect the work of other financial institutions and reduce people's confidence in the whole financial system, as well as in the national currency;
- iv. a bank has much more stakeholders, which makes the governance and control model much more complex;
- v. banks are subject to special regulations, aimed at ensuring the necessary financing for the economy while diversifying risks;
- vi. the failure to implement effective governance policies can change substantially the behavior of shareholders and managers by reducing risk aversion and blocking the financial intermediation process.

Given these features, corporate governance for banks should be seen as a necessity that would 'force' bank managers to protect the interests of all stakeholders, while proving a responsible behavior and attitude. The corporate governance mechanism must also provide the necessary transparency to maintain public confidence in the financial system, which is an essential element in financing the economy. Last but not least, key persons that are part of the corporate governance mechanism must prove, at any time, that they have the required skills and reputation for position held. In this respect, the international practice uses the 'fit & proper' concept to² assess the bank managers and shareholders.

In the context of the reforms initiated in the banking sector, the national banking legislation on corporate governance provides for the implementation of the latest international practices, namely Basel III standards. Thus, the new banking law and the Regulation on banks' activity management framework³ define the governing bodies of a bank (Board and the executive body), including their duties, qualification requirements of members and, importantly - accountability for the results obtained. The regulatory framework also stipulates the requirements for shareholders and envisages how to apply the governance principles across all governance levels depending on the size and complexity of each bank's

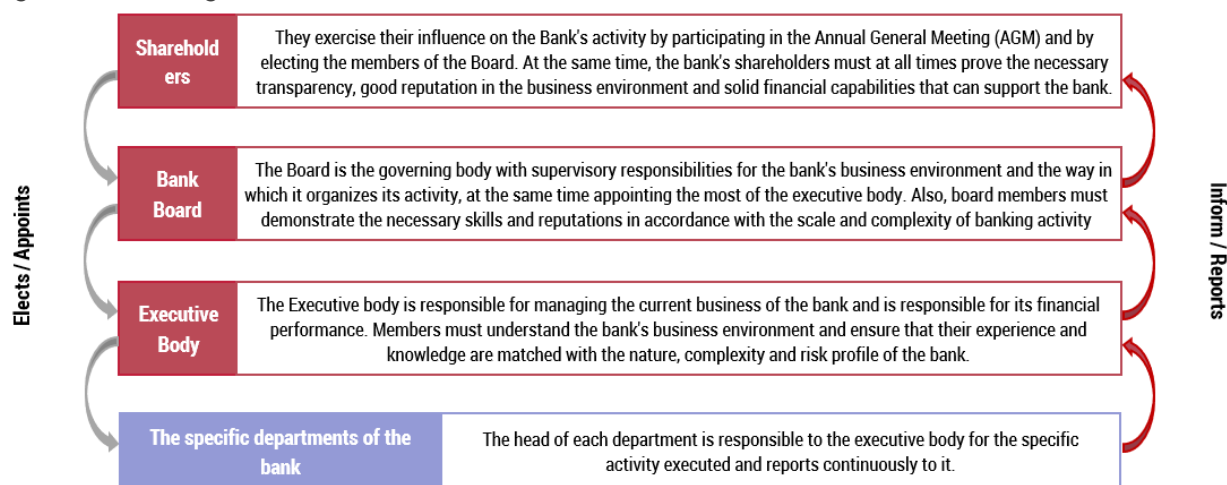
¹ The term 'stakeholders' defines an individual, an organization or a Government that has interests in a project or entity. In a bank, stakeholders are the persons who contribute, voluntarily or involuntarily, to creating added value, i.e. potential beneficiaries to profit or risks. These may be shareholders, depositors, customers, supervisory authority, Government, etc.

² The term 'fit & proper' implies assessing the professional and reputation skills of key persons in financial institutions and determining their suitability for the position held.

³ Law No 202 of 06.10.17 on the Activity of Banks and the Regulation on banks' activity management framework, approved by the NBM Decision No 146 of 07.06.2017.

activity. These requirements are to be gradually implemented by all commercial banks operating on the territory of the Republic of Moldova, sanctions and remedial measures being foreseen for those who will not comply. Figure 1 presents the standard bank corporate governance model, provided by national legislation.

Figure 1. National governance framework of commercial banks



Source: Author's compilation based on the Law on Banking Activity and the Regulation on banks' activity management framework

Governance principles for commercial banks

Applying and implementing an effective corporate governance mechanism in financial institutions requires relevant regulations and well-defined guidelines. Although theoretically the legislation in the field provides for a standard model of corporate governance, it cannot be implemented identically by all banks, given the different sizes and complexity of the activity of each institution. Even so, the purpose and general objectives must be permanently achieved by all banks, with the expected result materializing as a banking activity taking place in reasonable risk conditions and ensuring the protection of the interests of all stakeholders. Given this goal, the international banking regulatory bodies⁴ have started paying special attention to the principles of corporate governance, which have developed periodically depending on developments in the sector. These principles are to be implemented in the national banking system, the most important of which focus on the following:

Management practices of the governing bodies - activity of governing body members should be based on appropriate practices of governance and communication, both vertically and horizontally, which need to be reviewed periodically to make sure that they remain effective;

Composition and qualification of members of the governing bodies - members of the governing bodies and other key persons must be and remain sufficiently qualified, both individually and collectively, for their functions and responsibilities. They need to understand their role in the corporate governance mechanism and exercise an objective, integral and fair assessment of the bank's activity;

Board - this governing body has the overall responsibility for the bank's activity, including making sure that the executive body approves, supervises and implements the strategic objectives, the corporate governance framework and corporate culture according to ethics and integrity principles;

Executive body - under the direction and supervision of the Board, the executive body must perform and manage the bank's activity in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the Board;

⁴ E.g. Basel Committee on Banking Supervision, <https://www.bis.org/bcbs/publ/d328.pdf>

Risk management function - banks must have an independent and effective risk prevention and management function in the form of a committee that informs and reports directly to the Board;

Internal audit function - banks need to set up and have an audit committee that will assess independently and objectively, impartially and objectively the efficiency of the bank's management framework and will report directly to the Board;

Remuneration - the remuneration model of the bank's employees is a key component of the governance structure and staff incentives through which the Board and top management promote good performance, adjust the behavior and corporate culture, and the bank's risk appetite;

Transparency and disclosure of information - the mechanism and process of corporate governance must be sufficiently transparent to shareholders, depositors and other relevant stakeholders, thereby contributing to maintaining confidence in banking institutions;

Role of the national regulatory and supervisory body - the regulatory and supervisory authority (NBM) should provide guidance on the implementation of corporate governance principles and supervise their application by banks, including through comprehensive assessments and regular interaction with the bank's Board members and top management. It also should have the capacity to prevent possible misconduct and to correct the behavior of the bank's key persons through sanctions and remedial measures.