Corporate Governance of Banks: With Special Reference to

Sri Lanka

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Abstract

This study seeks to provide an understanding on corporate governance of banks. Corporate governance failures of banks have figured prominently in discussion and debate on the possible causes following the recent global financial meltdown. The paper argues that because banks are characterised by a high level of leverage, opacity and regulation, they require a special attention in corporate governance. Such features tend to have implications for most of the corporate governance mechanisms of banks. Thus, a stakeholder approach is more appropriate to govern banks particularly to incorporate the interests of depositors. Although the regulatory framework that governs banks in Sri Lanka promotes corporate governance of banks implementing proper mechanisms for enforcing such laws and prudential regulations is equally important as developing them.

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1. Introduction
Many countries have experienced banking crises in the last few decades. The failure of a major sector of the economy, such as the banking sector, or even of a single major bank, could result in a loss of investor confidence, leading to an unhealthy economic environment (Levine, 2004; Trayler, 2007). For instance, the failure of numerous financial institutions in a number of industrialized countries including the U.S. and members of the European Union led to the more recent global financial crisis. The causes of the global financial crisis more closely related to banks include insufficient board oversight of senior management, unduly complex or opaque bank organizational structures and activities, poor risk management practices, and excessive incentive schemes that were not closely related to the risk appetite of the bank and its longer term interests (Basel Committee, 2010; Clarke and Klettner, 2009; Turner Review, 2009; Walker Review, 2009). To a large extent, these factors are likely to be associated with weaknesses in corporate governance arrangements that failed to serve their purpose to safeguard against excessive risk taking in those institutions (Kirkpatrick, 2009).

This paper investigates corporate governance in the banking sector with particular attention to Sri Lanka. Corporate governance of banks plays an important role in developing countries such as Sri Lanka. Banks occupy a dominant position in the financial system in developing countries (Arun and Turner, 2004; Levine, 1997; Reaz and Arun, 2006). The banking sector in Sri Lanka, for example, dominates in the financial system, claiming approximately 58 per cent of the total financial institution assets in the country (Central Bank of Sri Lanka, 2007a). Banks are typically the main depository for their economy’s savings, and play a significant role in economic development as an important source of finance for investment (Arun and Turner, 2004; Levine, 2004; Nam, 2004).

The remainder of this paper is structured as follows. Section two introduces and defines corporate governance in general. Section three examines specific corporate governance issues and mechanisms of banks. Section four describes corporate governance arrangements in the banking sector in Sri Lanka. A summary of the paper and some concluding remarks are in the final section.
2. Corporate Governance

The term *corporate governance*, although used widely in the literature, lacks a generally accepted definition. In a narrow sense, corporate governance may mean the formal system of accountability of senior management to the shareholders (Keasey, Thompson and Wright, 1997). The board of directors (BOD), as the custodian of the shareholders, has a fiduciary duty to safeguard the interests of shareholders, and is held responsible for the governance of the firms. Accordingly, the Cadbury Report (1992) defines corporate governance as the system by which companies are directed and controlled. A broader view of corporate governance tends to incorporate more stakeholders into the governance framework. For example, Shleifer and Vishny (1997) define corporate governance as “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (p. 737). This definition incorporates the interests of both shareholders and debtholders. The OECD principles of corporate governance also seem to take a broad view, stating that “corporate governance involves a set of relationships between a company’s management, its board, its shareholders, and other stakeholders” (OECD, 2004, p. 11).

The importance of corporate governance lies primarily in the separation of management and ownership of companies. This issue has been discussed in the context of agency theory, which argues that the separation of corporate managers from outside investors leads to an inherent conflict of interests, and that the interests of investors need to be protected against expropriation by corporate managers (Bushman and Smith, 2001; Dey, 2008). Berle and Means (1932) appear to be the first to identify this problem in modern large companies, particularly in the U.S. They claimed that selfish managers embarked on ‘corporate plundering’ at the cost of outside widely spread owners, giving rise to contemporary corporate governance issues. Later, Jensen and Meckling (1976) viewed the relationship between management and owners in a firm as an agency relationship. Because of differences in goals and risk profiles of the two parties in the agency relationship there is often the possibility of an agent not performing in the best interest of the principal. Organizations therefore need to introduce appropriate mechanisms to address and manage such agency issues so that the interests of managers and owners can be aligned.
3. Corporate Governance in Banking Sector

3.1 Specific features of banks

The specific features of banks, namely leverage, opacity and regulation, distinguish their corporate governance from that of non-banking organizations such as manufacturing firms (Adams and Mehran, 2003; Nam, 2004). These features are discussed as follows.

**Leverage:** Unlike non-banking firms, banks typically operate with a high debt-to-equity ratio (Nam, 2004). Their capital structure tends to have very little equity and the liabilities are largely in the form of deposits, which are available to their creditors (depositors) on demand. On the other hand, the assets of banks often take the form of loans that have longer maturity, in contrast to the short term nature of their liabilities (Fan, 2004; Macey and O’Hara, 2003). This mismatch between the maturities of deposits and loans creates a problem for banks, where they become exposed to the risk of collective action by depositors. Therefore, the safeguard of depositor confidence is an important aspect of banks as a going concern.

**Opacity:** Information asymmetry is a common problem in all organizations where ownership and management are separated, but empirical evidence suggests that it is more critical in banks than in other firms (Levine, 2004). For instance, Nam (2004) argues that information asymmetry is higher in the banking sector than in non-banking sectors due to inter-temporal nature of typical financial contracts, which involve a promise to pay in the future. As a result, the risk composition of the assets in banks can change within a short period of time. Further, the increasing complexity of financial products and the use of advanced technology also have contributed adversely to this situation.

**Regulation:** The presence of a high level of regulation in the banking sector is another factor that differentiates banks from firms in other sectors. Governments influence banks’ activities by way of prudential regulation and supervision. These include, among other things, government deposit guarantees, restrictions on bank ownerships, regular audits, authorization of mergers among banks, capital adequacy requirements, asset composition rules, fit and proper standards for senior managers and board members, and the lender of the last resort function (Alexander, 2006; Fan, 2004). Such influence is necessary because the stability of the financial sector in a country
depends largely on the banks, and failure of a single bank can lead to the loss of public confidence in the total banking system (Nam, 2004).

3.2 The notion of corporate governance of banks

Traditional theories of the firm, such as agency theory which focuses on shareholder value maximization, may not be solely appropriate to discuss corporate governance of banks, as they focus only on shareholders and give limited attention to other stakeholders such as debtholders. The specific features of banks, as discussed in the previous sub-section, suggest that a corporate governance system for banks should protect the interests of other stakeholders, particularly depositors, in addition to the interests of shareholders. Bank failures, especially during the 1997/98 Asian financial crisis and the more recent global financial crisis, further support such arguments, as those failures adversely affected not only shareholders but also a larger spectrum of stakeholders, for example, depositors, customers, governments and by and large the general public of the countries. These arguments are in line with stakeholder view.

3.3 Corporate governance mechanisms in banks

The literature on corporate governance suggests that various mechanisms are used to align the interests of corporate managers with those of shareholders and other stakeholders (e.g., Bushman and Smith, 2001; Dey, 2008). The next sub-section discusses important corporate governance mechanisms related to banks.

Board of directors: The board is expected to play a significant role in a bank due to the inability of external corporate governance mechanisms (e.g., shareholder and debtholder monitoring) to operate at the same level as in non-banking firms (Andres and Vallezlado, 2008; Basel Committee, 2010; Nam, 2004; Walker Review, 2009). The fiduciary duty of the board is a valuable device in the banking context, because of the high level of information asymmetry (Macey and O’Hara, 2003). The literature suggests that the fiduciary duty of boards of banks should go beyond the protection of the interests of the shareholders to incorporate the interests of the depositors and regulators, as they also have a direct interest in the performance of banks. For example, the Basel Committee (2010) recommends that the boards of banks should meet their obligation of accountability to shareholders while taking into account the interests of other
stakeholders, namely depositors, supervisors, and governments, due to the unique role of banks in national and local economies and financial systems.

**Laws and regulations:** The high level of laws and regulations in the banking industry plays an important role in corporate governance. The literature provides arguments in favour of laws and regulations as an effective external corporate governance mechanism in banks. For instance, the opacity of banks hinders typical corporate governance mechanisms, such as shareholder and depositor monitoring, and thus governments replace those mechanisms by way of regulatory oversight (Levine, 2004). Further, the use of regulation is justified as it provides safety and soundness in the financial sector (Alexander, 2006).

**Shareholder monitoring:** Shareholders of banks appear to be less effective than those of non-banking firms in the monitoring process for several reasons. Firstly, the opacity of banks restricts the monitoring role of shareholders (Levine, 2004). Secondly, the high level of regulation can reduce the incentives of shareholders to monitor banks (Adams and Mehran, 2003). Large shareholders are also unlikely to exist in the banking industry due to the special laws on ownership restriction, and thus the ability of shareholders to monitor banks is reduced (Adams and Mehran, 2003). Finally, since banks operate under a high level of leverage, shareholders can benefit from the excessive risk taking behaviour of bank managers. Therefore, shareholders may not be concerned about excessive risk taking behaviour by bank managers.

**Debtholder monitoring:** The high level of debt-to-equity ratio of banks is expected to provide a strong incentive for debtholders to monitor banks. However, the ability and the interest of debtholders to monitor banks are restricted in several ways. The opacity of banks limits debtholders’ ability to monitor banks. Further, debtholder monitoring can be substituted by regulation and supervision, which can play a monitoring role in banks (Adams and Mehran, 2003; Levine, 2004). Finally, depositors lack incentive to monitor the banks in the presence of deposit insurance cover, as their invested money is protected regardless of the banks’ performance (Macey and O’Hara, 2003).

The discussion in this section suggests that the effectiveness of corporate governance mechanisms in banks is largely influenced by the specific features of banks, namely their high
levels of leverage, opacity and regulation. It shows the sector specific nature of corporate governance, and thus the need for separate examination of corporate governance of banks.

4. Corporate Governance in the Banking Sector in Sri Lanka

In recognition of the significance of the business of banks in the economy, the Central Bank of Sri Lanka issued a mandatory Code of Corporate Governance for banks in line with global developments in the area, effective from January 2008. This code aims to strengthen the boards of banks as an effective corporate governance mechanism. It consists of principles of corporate governance relating to eight areas, namely responsibilities of the board of directors (BOD), composition of the BOD, criteria to assess the fitness and propriety of directors, management functions delegated by the BOD, the chairperson and the chief executive officer, BOD appointed committees, related party transactions, and disclosures. These principles are particularly intended to strengthen the operation of the BOD as an effective corporate governance mechanism in banks.

Further, the CBSL, through its prudential regulations and supervisory practices, aims to improve the corporate governance of banks, for example, the directions for setting prudential norms for capital adequacy, asset classification and disclosure standards. Significant changes have recently been introduced into the laws and regulations applicable to banks. For example, in 2007, the ceiling on shareholding by a single shareholder or a group of related shareholders was restricted to a maximum of 15 per cent of the issued voting equity of the domestic private banks. In 2005, the minimum capital requirement for licensed commercial banks was increased to SLR 2.5bn from SLR 500m. It appears that these regulatory changes were mainly aimed at safeguarding the interests of the depositors in banks. Moreover, effective from January 2008, the CBSL implemented Basel II Accord to direct banks to create formal risk management structures (Fitch Ratings, 2007). It was also intended that the implementation of Basel II Accord would result in disciplining the banks in the market due to its high level of disclosure requirements (CBSL, 2007b).

Furthermore, the fully compliant with the international accounting standards by January 2012 is likely to strengthen the levels of external reporting of companies in Sri Lanka including banks. So, now, a bank that asserts compliance with LKAS would also be automatically compliant with
IFRS. Every licensed commercial bank is expected to publish its annual audited financial statements within 5 months after the end of the financial year. The CBSL also issued a guideline requiring all licensed banks to publish their quarterly accounts in a prescribed format within two months after the end of each quarter. Such requirements are intended to improve shareholder and debtholder monitoring of banks.

The presence of various regulatory requirements in the banking sector enables corporate governance to play an effective role in securing the interests of wider spectrum of stakeholders of banks. Various rulings and requirements generated in the banking sector seem not only to facilitate but also to reinforce the corporate governance of banks. Nevertheless, the existence of such laws and regulations does not necessarily ensure the desired outcomes. Hence, implementing effective and efficient mechanisms for enforcing such laws and prudential regulations is equally important as developing them.

5. Conclusion
This paper examined corporate governance of banks. Banks are characterized by high levels of leverage, opacity, and regulation, which hinder the efficiency of most corporate governance mechanisms that are operated effectively in other industries. Thus, banks raise unique corporate governance issues. As banks normally operate under a high level of debt-to-equity ratio, depositors play an important role for the existence of banks. Moreover, banks also have to consider the interests of other stakeholders, such as customers and governments, as failure to do so is likely to lead to a banking crisis. Hence, it can be argued that a corporate governance system to banks needs to accommodate a wider spectrum of stakeholders (e.g., Macey and O’Hara, 2003). Establishment and implementation of a similar corporate governance system for banks are mostly important in relation to developing countries, for example, Sri Lanka, because banks are typically the main depository for the economy’s savings, and play a significant role in economic development as an important source of finance for business.

References


