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Internal Governance

The primary responsibility for keeping individual banks sound lies with each bank's owners, directors, and managers. Together they must establish a framework of internal controls and practices to govern the operations of the bank and ensure that it functions in a safe and sound manner. As indicated in Table 14, poor internal governance was a factor in virtually all the instances of unsoundness in our sample.

Public policies must aim at limiting the negative externalities associated with bank failures. However, maintenance of a sound banking system depends on numerous factors, only some of which are directly influenced by policies. Public policies can reinforce incentives and market forces that encourage individual banks to remain sound. At the same time, such policies should not normally focus on individual banks but rather on the banking system as a whole. There may be cases in which a bank is considered "too big to fail," that is, it cannot be removed without damaging the system. Such a bank may be preserved and restructured, but its owners and managers should not be bailed out. It should be noted that the potential systemic repercussions of the failure of a large bank are often overstated; the case of Continental Illinois in the United States is an example (see Kaufman, 1990).

Ownership

The owners of a bank, and the directors they appoint, normally make every effort to see that the bank is well run and remains sound. A bank's owners are responsible for capitalizing the bank with sufficient resources to operate and to withstand reasonable losses. Owners with their own capital at risk have strong incentives to appoint competent directors and managers and to make every effort to see that these officers maintain the bank's profitability and solvency. An active market for corporate control will place pressure on owners and managers to maintain the bank in sound

Table 14. Deficiencies in Internal Governance[1]

Argentina (1980–82): Banks knew little about their clients and allowed speculative and distress borrowing. Accounting was weak.

(1989–90): Portfolios were not diversified, and banks lent heavily to the public sector. Public sector banks were inefficient and had very high levels of employment. Accounting was still weak. Banking was subject to political direction.

(1995): State banks were still weak. Banks were not diversifiied or automated and they made a large share of their loans in dollars. Accounting improved only in 1994.

Bangladesh (1980s–present): There is poor corporate governance with weak accountability and extensive insider lending. State-owned banks that account for two-thirds of deposits have very weak management and accounting systems. Political interference in lending occurred throughout the period.

Bolivia (1994–present): Troubled banks have several problems: concentrated ownership, extensive insider and related-party lending, weak internal controls, a lack of a clear division of internal responsibilities, low efficiency, and high costs.

Brazil (1994–present): Management was poor at some state banks that were not run on a commercial basis. The same applied to some private banks that did not diversify risks well. Some banks did not adjust quickly to the postinflationary environment.

Chile (1981–86): Banks were undercapitalized with respect to their historic averages. Loans to controlled companies were used to finance speculative asset purchases. From 1980, there was a sharp increase in "distress borrowing," rolling over bad loans, and capitalizing interest due.

Czech Republic (1991–present): Banks are inefficient and overstaffed, and shareholders exert pressure to obtain loans on preferential terms. Some small banks funded their loans in the overnight interbank market.

Egypt (1991–95): Domination of banking activities by 4 state-owned commercial banks is a problem.

Estonia (1992–95): Banks were not diversified and extended insider loans to owners. Credit-assessment skills were undeveloped and banks had weak accounting systems and inadequate classification and provisioning systems for bad debts.

Finland (1991–94): Banks had low capital, were not diversified, and engaged in aggressive, concentrated lending. Management focused on gaining market share rather than on risk analysis. Corporate lending to a large extent was in foreign currency. Auditing was lax.

France (1991–95): Internal controls have improved markedly in recent years and are broadly appropriate, although increased separation of back-office operations is still desirable. More generally, state shareholding in several banks (e.g., Crédit Lyonnais) poses specific problems.

Ghana (1983–89): Inadequate management, information, and internal control systems led to high operating expenses and even fraud. Loan losses were not recognized. There was no uniform system of asset classification or provisioning. Accounting standards were not uniform or were inappropriate.

Table 14 *(continued)*

Hungary (1987–present): Fraud occurred at 2 failed banks. Banks have too many branches and are overstaffed. There is adverse selection of borrowers at state-owned banks.

Indonesia (1992–present): State banks have been poorly managed in the past and have been subject to political interference. Industrial ownership of private banks has sometimes led to intragroup lending in excess of the legal limits on large exposures.

Japan (1992–present): The main bank system has led to selected lending. Accounting systems and internal controls were weak at some banks (e.g., Daiwa Bank). Banks' financial technology lagged behind their growth. They were not diversified, made inadequate provisions for problem loans, and grew rapidly in a quest for market share.

Kazakstan (1991–95): Management has no clear strategy. Speculation in foreign exchange produced profits but banks have no concept of how to grant and manage credits. Loans are rolled over and interest is capitalized. Lending is often concentrated or extended to related parties.

Kuwait (1990–91): Internal governance appears to have been adequate.

Latvia (1995–present): Risk-assessment skills are lacking; management is poor and accounting systems are weak. Major problems have been high foreign exchange exposure, insider lending, and fraud.

Lithuania (1995–present): The country's banks suffered from political interference in lending, inherited from Soviet times. Management is poor at state-controlled banks and private banks alike. In some cases, shareholders have seriously misused their rights.

Malaysia (1985–88): Banks were often under family control. Some smaller institutions lacked a code of ethics, internal controls, audit committees, and Chinese walls, so that fraud occurred. Institutions engaging in new activities (such as finance companies) often lacked professional expertise and fast growth overstretched their managerial resources. Risks increased rapidly (the loan-to-deposit ratio reached 90%) and distress borrowing was permitted. Management was not used to dealing with bad loans in an expanding, inflationary economy.

Mexico (1994–present): After many years of nationalized banking (from 1982 to mid-1992), commercial banks lacked the experience and organizational and information systems to adequately assess credit and other market risks and to monitor and collect loans. Accounting practices did not follow international standards. Concentration of loans and loans to related parties was a problem in those banks that were subsequently subject to official intervention.

Norway (1987–93): There were problems with high leverage, fast and concentrated growth in risky assets (especially in real estate), and lax auditing.

Pakistan (1980-present): State ownership has been a problem—state banks have been subject to political pressure to lend and to withhold debt-recovery efforts. Political interference in lending and weak collection have hurt banks.

Paraguay (1995–present): Insider lending and risk concentration was high and there was excessive illegal (off the books) deposit taking by banks.

Philippines (1981–87): There were weak banking and accounting practices and portfolios were not diversified. State banks owned 36% of banking assets. Commercial ownership through groups was high, leading to connected lending, interlocking directorships, and excessive risk taking.

Table 14 ***(concluded)***

Poland (1991–present): Political interference has occurred at some state banks. Banks were overstaffed and had poor management and information systems. New accounting standards were introduced in 1995.

Russia (1992–present): Weak internal controls and management practices have contributed to falling profitability and fraud. Accounting standards are weak. The central bank has introduced improved reporting requirements but the underlying chart of accounts is inadequate.

Spain (1977–85): Banks were not diversified, and credit was politically directed, which discouraged the development of credit-evaluation skills. Accounting was not consolidated.

Sweden (1990–93): Loan administration was poor and systems for credit monitoring were lacking. Pricing did not adequately reflect risk. There was an undue concentration of bank portfolios on real estate, and competition to lend to the real estate sector was destructive.

Tanzania (1988–present): Management and internal controls at state banks were weak. These banks were inefficient, overstaffed, and not run for profit. There was political interference in bank structure and lending for most of the period from 1967 to 1994. Accounting, auditing, reporting, and credit assessment were weak.

Thailand (1983–87): Banks were run by a few families, who were not professional bankers. Management weaknesses were pronounced especially at finance and securities companies. Ownership was concentrated, with little outside shareholder discipline. Internal controls were inadequate and there was heavy insider lending and high expenditure on banks' offices. Accounting was weak.

Turkey (1994): Industrial owners of banks pressured for subsidized loans. Accounts were not adjusted for inflation. There were deficiencies in risk analysis and risk management especially regarding foreign positions, leading to speculation. Banks had poor (unaudited) information on their borrowers. Banks are overstaffed and overbranched. There has been fast growth, especially in the off-balance-sheet activities.

United States (1980-92): In general, management and internal controls were adequate at the banks that survived, but they were seriously deficient at many banks and thrifts that failed. Savings-and-loan regulators encouraged "phony" accounting to hide net worth deficiencies. There was also political interference in lending in the thrift industry. Accounting even at banks ignored off-balance-sheet activities until the late 1980s and was slow to acknowledge the importance of market valuation.

Venezuela (1994–present): Banks had inefficient operations with high costs and extensive branch networks and offshore operations. There was weak accounting, extensive insider lending, and rampant fraud.

Zambia (1994–present): Banks had weak management and internal controls. They engaged in risky activities, including derivatives, and experienced very fast growth (assets quadrupled in two years). There has been political interference in banking, and incentives for performance at the large state bank are weak.

[1] Years in parentheses denote the period of banking problems.

condition.[70] The threat of losing their capital or forfeiting control of their bank through bankruptcy, corporate takeover, or official intervention should compel most owners to exert good internal governance.

The incentive structure is usually different for state-owned banks, which may have other operational objectives than profitability and soundness. Governments do not face market pressure for corporate control and taxpayers do not monitor their stakes in state-owned banks as well as shareholders in private banks monitor theirs.[71] Special efforts need to be made to ensure that incentives for directors and managers to keep a state-owned bank operating on a sound commercial basis are in place. In practice, this is difficult to accomplish; in many cases, full or partial privatization is the only way to insulate bank management from political interference and to ensure also that capital markets can discipline the owners. Banks that are, or were recently, state owned were a factor in most of the instances of unsoundness in the sample (see Table 14).

Private ownership per se does not guarantee good governance, however. Some private bank ownership structures can result in incentives to operate the bank in an unsafe and unsound manner. Banks may be misused, for example, as captive sources of finance for owners who are reluctant to service their loans. Insider lending or lending to related enterprises has been a principal factor contributing to banking sector problems in numerous countries. In many of the cases illustrated in Table 14, banks were part of financial groups that were able to engage in insider lending through complex off-balance-sheet and offshore transactions that made it difficult to track the loans and enabled the banks to hide their losses. When private owners' motivation for owning banks is essentially to rob them, internal governance will be insufficient to ensure the soundness of these banks. It should also be noted that in some environments, private ownership does not insulate a bank from political pressure for directed lending.

Management

Banks assume risk in the course of their business and the role of their managements is to assess and manage that risk. Among privately owned U.S. banks, most bank failures may be traced to poor management.[72] Among state-owned banks, failures often are due to political interference, but management failures are an important factor as well. Lax manage-

[70] See Prowse (1995).

[71] See Kane (1995) for a discussion of this aspect of state ownership.

[72] Evidence on this for the U.S. case is discussed in U.S. Office of the Comptroller of the Currency (1988), Sienns (1992), and Barker and Holdsworth (1993).

ment can result in failure to institute appropriate procedures and controls to limit risk exposures and to ensure that the bank carries out its principal functions in a safe and sound manner.

Management should strive to maintain the value of the bank by ensuring that the asset portfolio is sound and produces sufficient income. Loans constitute the most important class of bank assets; despite the increase in other types of business, the most common reason for bank failures remains losses from bad credit decisions. It should be recalled that credit losses at Crédit Lyonnais in France alone are estimated at around $10 billion, while all the recent well-publicized, derivatives-related losses worldwide only amount to some $15 billion. It is the responsibility of a bank's management to ensure that credit appraisal and valuation are handled properly and that the asset portfolio is properly diversified. It becomes more difficult to distinguish good from bad borrowers when bank loans are growing rapidly (see Hausmann and Gavin, 1995); management must ensure that growth in loans is not so rapid that credit quality is sacrificed. Many loans that are sound at their inception develop into losses because of lax credit administration. Good management will institute appropriate policies and procedures for internal loan review and for early intervention in problem asset situations.

The valuation of the asset portfolio should take into account borrower-specific credit risk and overall economic risk factors. Bank management also needs to ensure that the bank is not exposed to excessive liquidity risk. While maturity transformation is a key function of banks, a sound bank holds sufficient liquid assets to enable it to meet reasonable levels of deposit withdrawals without forced liquidation of portfolio assets. Thus, good bank managers assess their bank's liability structure, project how liquidity would be affected by adverse events, and determine if the bank's asset position is appropriate.

Banks encounter risks from abrupt shifts in exchange rates or interest rates. Exposure to foreign exchange losses depends on the relative balance of foreign exchange assets and liabilities in the bank's portfolio. When banks convert borrowed funds into domestic currency, they face foreign exchange risk; if they on-lend the foreign currency, their borrowers may default as a result of foreign exchange exposure. In some markets, exchange risk can be hedged; in any market, it can be limited through appropriate exposure management. Interest rate risk arises from a maturity mismatch between assets and liabilities and may be managed through appropriate liquidity matching or interest rate adjustment practices. Exchange rate and interest rate exposure may be explicit in the balance sheet or may be implicit in off-balance-sheet transactions, such as swaps and other derivatives. Off-balance-sheet transactions also involve credit risk, which must be evaluated like the credit risk in regular lending. For

all these risks, it is the responsibility of management to monitor the portfolio and to ensure that exposures remain within the limits determined by the owners and top management.

Banks are increasingly exposed to risks stemming from their participation in securities, commodities, and derivative markets. Many of these risks can be readily broken down into constituent interest rate, exchange rate, or credit risk elements. However, the complex nature of some of the positions now being taken by the trading desks and investment arms of banks places greater demands on management to understand, monitor, and limit the risks assumed.

Finally, banks continue to be subject to operational and reputational risks linked to the fact that they are, after all, organizations designed and operated by humans. The danger of direct financial loss or loss of reputation (and clients) due to errors and fraud will therefore always be present. Here, too, the primary onus is on a bank's management to ensure that personnel and operating policies minimize the organizational hazards.

Internal Oversight

Owners and managers normally have a common interest in establishing internal systems to provide accurate reporting on the bank's condition and to monitor and control risk. Such systems must include accounting procedures that adhere to generally accepted standards, but extend also to reporting systems that properly value the bank's asset portfolio and indicate its risk exposure, and internal procedures to ensure that risks are not assumed unintentionally or inappropriately. Internal control systems should also provide managers with the information necessary to monitor the bank's compliance with laws and regulations, and to follow up on any corrective action being taken. Lax accounting or audit were identified as contributors to more than half the instances of unsoundness in our sample (see Table 14).

Banks are particularly exposed to internal risk in the form of incompetence, dereliction of duty, or fraud. Thorough internal and external audits and written policies and procedures help control these risks. Managers and directors must possess a full understanding of the financial instruments and markets in which the bank does business, be able to monitor their subordinates' activities, implement internal controls, and understand audit and other data depicting the bank's position. Where there is a clear potential for problems, rules and procedures are needed to control behavior. For example, it may be difficult to apply objective standards to loans to insiders, so rules are needed to limit such lending and to subject insider loans to special oversight.

Governance Failures

Internal governance may fail to ensure the soundness of a bank for a number of reasons, most of which relate to conflicts of interest and information asymmetries. Bank creditors' earnings are typically fixed or independent of the return generated by the actual use of their funds, so owners and managers may attempt to garner higher profits by making riskier investments, whose benefits accrue solely to them. Furthermore, owners whose main goal is to use the bank as a captive source of funding for other enterprises may not be concerned with the safety of the bank, since a collapse harms depositors and other creditors more than the borrowers or owners (see Garcia and Saal, 1996).

Similarly, while capital provides a bank with a cushion against losses, owners have incentives to put as little capital at risk as possible. Income recognition and loan-valuation rules are prone to manipulation by banks wishing to show higher profits or capital. By manipulating the classification of nonperforming loans, restructuring nonperforming loans without classifying them, including as income the interest accrued on nonperforming loans, or rolling over principal and interest into new loans ("evergreening"), banks can show accounting earnings and inflate asset values even when in fact they are incurring losses. In many Latin American countries, accounting standards were so lax that banking systems were reporting positive net income even during a banking crisis (Rojas-Suárez and Weisbrod, 1995). For example, evergreening contributed to the banking crisis in Chile in the early 1980s (Brock, 1992). The problem is not limited to less-developed economies; U.S. banks with low capitalization have apparently been able to manipulate accrual estimates so as to reduce loan-loss provisions (Kim and Kross, 1995) and appear to choose their charge-offs and provisions to manage the level of bank capital rather than to reflect loan quality (Beatty, Chamberlain, and Magliola, 1993).

Assuring that banks are well managed may be made more difficult by conflicts of interest between owners and managers. Owners may not have the information necessary to prevent managers from furthering their own interests rather than pursuing the objective of maximizing the value of the bank. The ownership structure can also be a problem if shareholdings are so fragmented that the widely dispersed owners are unable to exercise effective control. Managers may take on excessive risk, since it is the owners whose capital is at stake, not the managers.[73] Managers may make excessive outlays on headquarter offices, equipment, furnishings, salaries, and benefits, which can dissipate earnings and may lead to loss of capital

[73] One factor contributing to the increase in risk inclination in recent years may be the rise of managers with market trading rather than traditional banking backgrounds.

and eventual insolvency. Where managerial income is related to earnings, managers may attempt to hide problems by overvaluing assets or showing improperly accrued earnings. These problems may be ameliorated by strong internal controls, which allow directors and owners to monitor manager behavior, by incentive contracts aligning managers' personal benefits with owners' goals, and by an active market for managerial services, which puts pressure on managers to maintain their reputations. In this regard, treating managers of state-owned banks as civil servants, with the attendant job security and salary scale, may blunt managers' performance incentives.