



**International Corporate Governance Network**  
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# Corporate Governance in Asia

## Part 1: A Perspective on Policy Reform for Banks

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**Asian banks play a dominant role in regional finance. Capital markets in many Asian economies are not yet as mature as in many market-oriented countries. The failure of corporate governance of banks in Asia has resulted in more serious economic consequences than in other regions.**

One of the key issues which led to the 1997 Asian financial crisis was the underdeveloped status of corporate governance within banks in the region. Consequently, the Asian Roundtable on Corporate Governance in Asia (Roundtable) in its 2003 *White Paper on Corporate Governance in Asia*, recognised corporate governance of banks as one of six priorities for reform. Governments were called upon to intensify their efforts to improve the regulation and corporate governance of banks. Modern doctrine on financial supervision relies on three factors for bank regulation: (i) the bank's internal governance; (ii) surveillance by the market of the banks; and (iii) official banking supervision and the majority of Roundtable economies have indeed made progress, most of the

efforts focused on the banks' internal governance. In some economies, efforts have also been undertaken to strengthen the role of the banking regulator.

### Recent Developments

Since 2003, substantive progress has been made by policymakers in almost all of the Asian Roundtable jurisdictions. For an overview of factual measures by individual banking supervisors in Asia, reference is made to the forthcoming *Stock-take Report by the Roundtable* (2006). However, considering the importance of corporate governance of banks in 2004, the Roundtable decided to set up a Task Force on Corporate Governance of Banks in Asia. The Task Force, which includes both banking supervisors and securities regulators, has drafted the *Policy Brief on Corporate Governance of Banks in Asia (Policy Brief)* providing policy recommendations for further improvement in corporate governance of banks in Asia; it also refers to the challenges and obstacles to achieve such improvements. The *Policy Brief* was issued at a joint conference by the OECD and the Bank for International Settlements (Financial

### Box 1 | Other Reasons Why Corporate Governance of Banks Differs from Non-financial Companies

- Shortcomings in corporate governance of banks, if widespread, can destabilise the financial system and pose systemic risks to the real economy.
- Banks need to be perceived as both accountable to depositors and credible (i.e., they need to protect themselves against reputation risks) in order to manage the potential risk of a run on bank deposits; consequently:
  - (i) banks are not free from the potential risk in which they suddenly become insolvent owing to the difference in maturity between liabilities (most deposits are available to depositors on demand) and assets (e.g., longer term loans) even if banks' assets are sound in reality
  - (ii) moreover, the quality of banks' main assets (loan portfolio) is often rather opaque to outsiders compared with those of non-financial firms.
- Banks and/or depositors frequently have access to government-sponsored safety nets such as deposit insurance schemes and the provision of liquidity by the central bank. These measures may reduce the incentives for the public (e.g., depositors) to monitor banks. Poor corporate governance of banks in such circumstances may increase the probability of bank failure leading to high costs for taxpayers.
- In addition to the usual institutional constraints that affect all firms, banks are subject to numerous prudential regulations. One can not discuss corporate governance of banks without considering the banking regulations with which banks have to comply. Securing (i) "regulatory governance" of supervisory institutions, and (ii) efficient regulation, is a prerequisite to ensure sound corporate governance of banks in general.

Source: *Policy Brief on Corporate Governance of Banks in Asia* (OECD 2006).

Stability Institute) in June 2006 in Hong Kong and will soon be available on the OECD Web site. This paper is intended to merely summarize the main topics of the *Policy Brief* and therefore should not be perceived as a substitute for the *Policy Brief*.

### **The Policy Brief on Corporate Governance of Banks in Asia**

The *Policy Brief* is a non-binding document which has been prepared on a consensus basis and seeks to identify objectives and suggest various means of achieving them. Moreover, with some exceptions, it does not address many of the corporate governance-related issues in banks that overlap with those issues that are also relevant to non-financial companies. In relation to the *Policy Brief*, reference should be made to the *Basel Committee on Banking Supervision*, which has recently revised<sup>1</sup> its guidance on *Enhancing Corporate Governance for Banking Organisations*.

There are many bodies that are involved in ensuring sound corporate governance of banks. The primary responsibility for developing and implementing sound corporate governance of banks rests with the individual bank itself. Private bodies such as banking industry associations or institutes of directors often play an important role in assisting boards of directors and senior management of banks in fulfilling their responsibilities.

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Banking supervisors, on the other hand, have the responsibility to provide a regulatory framework and guidance in terms of corporate governance of banks; they should also monitor individual banks, taking necessary measures when a bank fails to achieve the minimum corporate governance standards necessary for the banking business.

In addition, the corporate governance framework (not only of banks, but of any corporation) typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition.

## **Box 2 | Nine Priorities For Policy Reform In Corporate Governance Of Banks In Asia**

- The responsibilities of individual board members in Asian banks.
- The roles and functions of the board in Asian banks.
- The composition of the board.
- The committees of the board.
- Appropriate credit allocation preventing abusive related party transactions.
- Bank holding companies and groups of companies containing banks.
- Disclosure.
- Banks' autonomy in relation to the state.
- Banks' monitoring of the corporate governance structure of its corporate borrowers.

*Source: Policy Brief on Corporate Governance of Banks in Asia (OECD 2006).*

Therefore, the *Policy Brief* is addressed to a wide range of targets, including banks, banking industry associations, institutes of directors, stock exchanges, capital market regulators and banking supervisors. Some recommendations can be implemented by banks, banking industry associations or banking supervisors, while others fall within the jurisdiction of capital market regulators or stock exchanges.

### **Characteristics of Corporate Governance In Asian Banks**

In its first chapter, the *Policy Brief* explains why good corporate governance of banks in Asia is so important. Firstly, banks accept money largely in the form of deposits from the general public (i.e., depositors): the nature and amounts of each deposit varies considerably, ranging from large-lot corporate deposits to a number of small deposits in which members of the general public — who do not necessarily have enough knowledge of financial products — entrust their everyday savings. Banks are lending money that is in effect "borrowed" from these depositors, and the failure of banks could result in a monetary loss for the depositors. The interests of depositors should be protected, and for this reason the Task Force considers that corporate governance of banks differs from that of other companies and needs special care. The boards and management of banks have to pay more attention to the interests of these non-shareholding stakeholders (i.e., depositors) compared to non-financial firms. Box 1 sets out some other reasons why corporate governance of banks differs from non-financial companies and therefore needs special attention.

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#### **Priorities for Policy Reform**

Nine priorities are identified in the *Policy Brief* (see Box 2) for Asian policymakers to focus on in their efforts to improve corporate governance of banks in the region. The recommendations are wide by nature. The *Policy Brief* explicitly states that it is not intended to specify a special treatment for small banks; nor does it mean that all banks, from large, internationally competitive banks to small, community banks, should adopt exactly the same measures to improve their corporate governance regardless of their capacity. Moreover, although the *Policy Brief* is oriented towards identifying corporate governance issues that affect banks and banking in general, it also addresses certain issues that are more relevant to specific types of banks, for example, state-owned commercial banks and family-owned banks, both of which are still predominant in a number of Asian jurisdictions.

#### **Concluding Remarks**

Discussions about corporate governance of banks in Asia need to take into account a number of factors specific, if not exclusively unique, to the region. As set out in the 2003 *White Paper*, reflecting the varying legal, economic and cultural backgrounds in Asia, corporate governance practices are diverse. While most Asian jurisdictions have substantially revamped their corporate governance laws, regulations and standards in recent years, challenges lie in their implementation and enforcement<sup>2</sup>. Reflecting the relatively short history of development in the region, many Asian jurisdictions do not have in place the institutional infrastructure necessary for effective enforcement (e.g., sufficient resources, experience, focus and know-how). Policy makers should be aware that sound corporate governance of banks cannot be developed effectively without tackling institutional constraints and weaknesses. Banking supervisors should put more emphasis on improving corporate governance and provide incentives for banks to do so because, together with effective banking supervision, it would greatly contribute to ensuring sound banking and stable financial systems. Banking supervisors should also cooperate with other relevant bodies such as securities regulators and stock exchange. The *Policy Brief* contains a subject for collaboration, i.e., the development of a specific code of corporate governance for banks, a basis on which banks should develop their own codes, taking into account the conditions of each jurisdiction and existing generic corporate governance codes. ♦

<sup>1</sup>13 February 2006

<sup>2</sup>In this respect, reference is made to the forthcoming 2006 *Stock-take Report* by the Asian Roundtable on Corporate Governance.

