Setting the rules of the game

By Nicholas Bray

As the financial crisis morphs into a sovereign debt crisis, the corporate governance of banks is back under the spotlight. Whose interests should bank boards be serving? And who should be monitoring what banks do? INSEAD Professor Jean Dermine shares his views.

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A year ago, the Walker Review of corporate governance in financial institutions in the United Kingdom took the view that the primary role of boards was to look after the interests of shareholders. More recently, both the Basel Committee on Banking Supervision and the European Commission have proposed broadening the role of boards to consideration of the interests of depositors and other stakeholders.

That’s a major shift of emphasis, according to INSEAD Professor of Banking and Finance **Jean Dermine**, and in his view it is vital not to mix up the issues. Recent events clearly show that in many cases boards were not fully informed about the risks being taken by the institutions they were supposed to be overseeing, he acknowledges. Equally, however, many existing safeguards were simply not enforced by regulators, raising questions about their role.

As governments the world over ponder how to stave off the next financial crisis, Dermine has two clear recommendations:

• Governments and banking authorities should set the rules of the game and ensure the safety of the banking system.
• Bank boards should work within these rules for the long-term interests of their company, with a particular eye open to the risks that may derive from innovations.

“When we address these issues, (the debate) should not be driven at all by ideology. It should not be ‘the bad boys of capitalism’ versus a new system”, Dermine says. Instead, he asserts, “we should have a cold analysis of what’s good for society.”

On the regulatory front, Dermine urges more emphasis on watching credit risks and trading risks. While liquidity risks need to be followed too, it “is extremely rarely the first source of the problem. In banking, most of the time, it is first credit losses and sometimes trading losses that generate a panic.”

As a corollary, he underscores the need for greater independence for regulators. Because of political pressures, he notes, the European stress tests of banks conducted last July failed to recognise the full extent of risk in bank lending on real estate in some countries.

“When you read the stress tests, you can say these were not stress tests at all. In the case of Spain, they were looking at a drop in the price of real estate of 15 per cent. At the same time, if you were reading The Economist … its report was saying that possibly this market is overvalued by 50 per cent. The difference is huge … This shows clearly what happens when regulators or banking supervisors are not independent of the public authorities.”

In parallel, Dermine asserts, boards need to be more vigorous in overseeing the activities of the financial institutions they are guiding. Rather than more people with financial expertise, “we need individuals with character who will be strong enough to oppose a CEO that may have a very short-term view. The mission of the board is to look at the long-term interest of a firm. There, clearly, you need character at the level of board members.”

That’s not to say that banks should avoid risk completely. In a changing world, companies need to innovate and innovations create new sources of risk. The role of the board is to identify likely outcomes, both positive and negative, and take appropriate decisions.

That’s where full information is essential. “For a board, it is of vital importance that they are made aware of stress tests (and) under which conditions, which type of risks, their bank could go under, and then they decide how to position the bank … If the board has to take into account the long-term interests of a company … clearly (it) has to make sure that the company is able to grow through a shock in the economy.”

Will Europe’s banking sector get to a point where it has adequate risk controls and supervision? The situation is complicated by the fact that different countries have differing bankruptcy regimes. Changing that will require a deliberate political decision on the part of governments. “In my view, it is only when creditors will be at risk that there will be enough pressure to limit the risk of the banking system,” Dermine observes.

On the other hand, however, he also sees reasons for optimism. ”Firstly, banks have raised a very large amount of capital in the last two years, so their capital ratios are much higher than before the crisis. And secondly, in many countries, retail banking is quite profitable, so the potential profitability of banks is quite nice.”

This article was written by Nick Bray based on an interview for INSEAD Knowledge.

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