Corporate governance and banks: The role of regulation in reducing the principal-agent problem

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ABSTRACT

The purpose of this paper is to analyse some of the important issues concerning the corporate governance of banks and financial institutions and the related issues of financial regulation. The paper argues that corporate governance of banks is largely concerned with reducing the social costs of bank risk-taking and that the regulator is uniquely positioned to balance the relevant stakeholder interests in devising governance standards for financial institutions that achieve economic development objectives, while minimising the externalities of systemic risk. The paper also analyses recent international initiatives in the area of corporate governance and banking, including some of the proposals of the Basel Committee on Banking Supervision. The paper then reviews the legal and regulatory framework of corporate governance in the United Kingdom for banks to illustrate some of the strengths and weaknesses of the UK approach, and to suggest possible regulatory techniques for other jurisdictions.

INTRODUCTION

The corporate governance of banks and financial institutions has become an important area of financial regulation because of the systemic risks that banking activity poses for the economy and society at large. Following the US savings and loan crisis in the 1980s and the Asian financial crises in the 1990s, most experts recognised that effective prudential regulatory regimes for the banking sector require strong corporate governance frameworks for banks and financial institutions. Most of the literature on corporate governance has addressed the governance issues confronting companies and firms in the non-financial sector.[1] Most of these studies take the principal-agent problem as the starting point of analysis, in which the principal is the owner/shareholder of the firm and the agent is the manager/employee of the firm. This paper suggests that the traditional model of the principal-agent problem fails to take account of the important role that financial regulation can play in representing stakeholder interests in the economy. Recent international initiatives in the area of banking regulation provide some general principles for how regulators can balance the interests of owners, managers and other stakeholder interest in society. UK financial regulation establishes a legal basis for corporate governance standards for banks and financial sector firms that seems to address some of the manifestations of the principal-agent problem in the financial sector.

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The main rationale of bank regulation has traditionally been the safety and soundness of the financial sector and protection of depositors.[2] A safe and sound banking system requires the effective control of systemic risk.[3] Systemic risk arises because banks have an incentive to underprice financial risk because they do not incur the full social costs of their risk-taking.[4] The social costs of bank risk-taking can arise from the solvency risks posed by banks because of imprudent lending and trading activity, or from the risks posed to depositors because of inadequate deposit insurance that can induce a bank run.[5] Systemic risk can also arise from problems with payment and settlement systems or from some type of financial failure that induces a macroeconomic crisis.[6] These sources of systemic risk demonstrate the fragility of the banking sector and the need to develop adequate corporate governance arrangements to incentivise bank management and owners to undertake a level of risk that does not create substantial social costs for the economy.

Bank regulation has traditionally sought to mitigate these social costs by adopting various prudential measures, including deposit insurance, capital adequacy requirements, asset composition rules, and fit and proper standards for bank officers, senior management and board members.[7] The main function of bank prudential regulation is to address the social costs which bank risk-taking creates by adopting controls and incentives that induce banks to price financial risk more efficiently. Corporate governance plays an important role in achieving this in two ways: to align the incentives of bank owners and managers so that managers seek wealth maximisation for owners, while not jeopardising the bank's franchise value through excessive risk-taking; and to incentivise bank management to price financial risk in a way that covers its social costs. The latter objective is what distinguishes bank corporate governance from other areas of corporate governance because of the potential social costs that banking can have on the broader economy. Moreover, it should be noted that regulatory intervention is necessary to address the social costs of bank risk-taking because the regulator is uniquely situated to assert the varied interests of other stakeholders in society and to balance those interests according to the public interest.

WHY BANKS ARE SPECIAL AND THE PRINCIPAL-AGENT PROBLEM

The role of banks is integral to any economy. They provide financing for commercial enterprises, access to payment systems, and a variety of retail financial services for the economy at large. Some banks have a broader impact on the macro sector of the economy, facilitating the transmission of monetary policy by making credit and liquidity available in difficult market conditions.[8] The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing, in many cases, a government safety net to compensate depositors when banks fail. Financial regulation is necessary because of the multiplier effect that banking activities have on the rest of the economy. The large number of stakeholders (such as employees, customers, suppliers etc), whose economic well-being depends on the health of the banking industry, depend on a well-regulated and supervised banking sector. Indeed, in a healthy banking system, the supervisors and regulators themselves are agents acting on behalf of broader stakeholder interests in the economy at large. Efficient banking regulation involves the promulgation of substantive standards (eg capital adequacy and fit and proper standards) and risk management procedures for financial institutions in which regulatory risk measures correspond to the overall economic and operational

risk faced by a bank. Accordingly, it is imperative that financial regulators ensure that banking and other financial institutions have strong governance structures, especially in light of the pervasive changes in the nature and structure of both the banking industry and the regulation which governs its activities.

For most stakeholders, such as employees, customers, suppliers etc, their economic welfare depends on the safety and soundness of the banking system and, more critically, the health of the economy. The special role of banks is recognised by the Basel Committee on Banking Supervision statement on Corporate Governance for Banking Organizations, which states:

> 'Banks are a critical component of any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access to government safety nets. It is of crucial importance therefore that banks have strong corporate governance.'[9]

Moreover, as mentioned above, strong bank corporate governance is necessary because of the social costs of bank risk-taking. For instance, a bank run can lead to a general loss of confidence in the banking system, which can quickly result in a spillover effect on other banks and even affect healthy banks via the payment system. It is important, therefore, that supervisors and regulators monitor the governance practices of banks in order to protect the interests of those who have an economic and social stake in the efficient performance of the banking sector. An important function of bank regulation should be to develop substantive standards of governance and process-oriented risk management guidelines that incentivise bank management and directors to take into account the overall economic and operational risk posed by financial institutions. This requires the adoption of robust governance structures that balances the various interests within and outside the banking organisation so that the social costs of bank risk-taking are minimised.

The principal-agent problem

The principal agent model has generally been concerned with how one individual (the principal) can design a contract which motives another person (the agent) to act in the principal's interest. The design 'principal-agent problem' was first used by Ross (Stephen Ross (1973) 'The economic theory of agency: The principal's problem' *American Economic Review*, Vol. 53, No. 2, pp. 134–39) to refer to the general problem of devising a contract to ensure that the agent pursues the principal's goals as efficiently as possible. The principal-agent problem usually arises from two sources: imperfect information, and misaligned incentives between the principal and agent. Imperfect information occurs when the principal cannot sufficiently monitor the agents' actions. For example, it is very difficult for a bank to monitor the actions of its borrowers, or for a bank owner to know the level of effort exerted by its officers and employees because of what Arrow (Kenneth Arrow (1965) *Aspects of the Theory of Risk-Bearing*, Chicago: Aldine-Atherton) classified as *hidden action* and *hidden information* problems. If the agents' actions are not observable, it is impossible to design a contract based on these actions. Moreover, the principal may delegate responsibility to the agent to make certain decisions based on information that is only available to the agent.

The other source of the principal-agent problem concerns the divergence of interests between the principal and agent. If the goals of these two parties were perfectly aligned, the agent would have an incentive to act in the way that the principal would wish it to act. Perfect alignment of interests, however, is difficult to achieve because the unobservable actions of the agent cannot be perfectly inferred based on observable data. For example, the agent's level of output cannot be used as a perfect measure of effort because other random factors may influence the agent's output independent of the agent's effort.

The principal-agent problem can manifest itself in two ways: *moral hazard* (hidden action), and *adverse selection* (hidden information). These problems arise from the informational advantages possessed by the agent at the principal's expense. *Moral hazard* can be defined as actions of economic agents to maximise their own utility to the detriment of others in situations where they do not bear the full costs or consequences of their actions. This may be due to the uncertainty and incomplete or restricted contracts which prevent the assignment of full costs/benefis to the agents responsible. Moral hazard is a form of *post-contractual* opportunism that involves the agent choosing to pursue his or her self-interest at the expense of the principal by deviating from the course of action that the principal would prefer the agent to take. Moral hazard is therefore associated with *hidden actions* in a contractual relationship. Hidden action involves actions that cannot be accurately observed or inferred by others, thus making it impossible to condition contracts on these actions.[10]

Adverse selection is another form of the principal-agent problem that applies to a market in which products or services of varying qualities are exchanged, and only sellers know the quality of the goods. Adverse selecton refers to a form of precontractual opportunism which arises when the agent has private information about something which affects the net benefit that the principal derives from the bargain. Adverse selection is therefore associated with *hidden information*. This means that the agent has some (possibly incomplete) information which determines the appropriateness of the agent's actions, but which are imperfectly observable by others. For instance, a borrower is likely to know a lot more about its ability to repay a loan than the lending bank. This means that high-risk borrowers can exploit this information asymmetry by portraying themselves as low-risk borrowers in order to obtain improved conditions on a bank loan.

The traditional principal-agent framework has been used to analyse bank risk-taking and how the incentives of shareholders, creditors and managers can diverge and thus undermine banking sector stability.[11] The main characteristic of the principal-agent problem is that some managers have the opportunity to engage in unobserved, socially costly behaviour.[12] The principal-agent problem can manifest itself in different risk preferences for bank managers as compared to shareholders and creditors, including depositors, and other stakeholders, such as employees, customers, and borrowers. Overcoming the principal-agent problem involves reducing the information asymmetries between these parties and aligning their incentives for risk-taking.[13] This can be difficult, however, because of high transaction costs and institutional barriers. Bank regulation is therefore necessary to ensure that the incentives of these groups are properly aligned and that the social costs of bank risk-taking are mitigated and that the transaction costs for banks in obtaining liquidity and access to the payment system are low.

Moreover, the principal-agent problem may also manifest itself within the context

of the bank playing the role of external monitor over the activities of third parties to whom it grants loans. In fact, when making loans, banks are concerned about two issues: the interest rate they receive on the loan, and the risk level of the loan. The interest rate charged, however, has two effects. First it sorts between potential borrowers (adverse selection)[14] and it affects the actions of borrowers (moral hazard).[15] These effects derive from the informational asymmetries present in the loan markets and hence the interest rate may not be the market-clearing price.[16]

In addition, a major challenge for corporate governance as it relates to banks and financial institutions involves a redefinition of the principal-agent problem to include the various types of market failure that cause financial instability in the banking sector. This means that banking regulation should be concerned not only with creating an incentive framework to induce management to achieve the objectives of the bank owners (eg shareholder wealth maximisation), but also to allow the regulator to balance the interests of the various stakeholder groups in the economy that are affected by bank risk-taking and reduce the social costs that are inevitably associated with poorly regulated banking activity.

Moral hazard and deposit insurance

The banking literature suggests that banks possess superior information regarding the viability of assets and that their primary function is to serve as delegated monitors on behalf of depositors with surplus capital.[17] Since depositors lack sufficient information to assess the riskiness of assets in the bank's portfolio, they are not able to successfully monitor banks. This information advantage (asymmetric information) of banks leads to moral hazard between the bank and the depositors. This means that bank owners (managers) have strong incentives to increase risk because they can transfer their risk to third parties while receiving any gains that might result from the risky behaviour. To address the potential risk to depositors, most developed countries provide some form of deposit insurance protection. For example, the US Government has provided generous deposit insurance on multiple accounts for depositors since the 1930s.[18] This has been criticised, however, as reducing the incentive of depositors to monitor the risky activities of bank management.[19] For instance, Merton showed that before 1991 the FDIC insurance premia rates were calculated on a fixed price basis for all insured deposits; and that this created a put-option-like subsidy for bank shareholders, which created an incentive for riskier lending and trading activities.[20]

In 1991, as a response to the savings and loan crisis of the 1980s, Congress sought to mitigate the moral hazard problem by enacting the Federal Deposit Insurance Corporation and Institutions Act 1991 (FDICIA). Under FDICIA, the Federal Deposit Insurance Corporation (FDIC) has been vested with discretionary authority to make determinations of unsafe and unsound banking practices in violation of the FDICIA that would place the insurance fund at risk.

FDICIA established a risk-based assessment system under which the premiums paid by federally insured financial institutions are based on risks the institutions pose to the insurance fund. Specifically, s. 302(a) of the FDICIA requires the FDIC to establish final risk-based assessment regulations, and s. 302(f) authorises the FDIC to promulgate transitional regulations governing the time period between the flat-rate assessment system and the risk-based assessment system required under s. 302(a). The FDIC adopted the transitional regulations on 15th September, 1992,[21] and subsequently adopted the final regulations on 17th June, 1993.[22] Both regulations were codified

under Title 12 of the Code of Federal Regulations § 327.[23]

In s. 302(a) of the FDICIA, Congress defined a 'risk-based assessment system' as:

> 'a system for calculating a depository institution's semiannual assessment based on —
> (i) the probability that the deposit insurance fund will incur a loss with respect to the institution, taking into consideration the risks attributable to —
>   (I) different categories and concentrations of assets;
>   (II) different categories and concentrations of liabilities, both insured and uninsured, contingent and non-contingent; and
>   (III) any other factors the [FDIC] determines are relevant to assessing such probability;
> (ii) the likely amount of any such loss; and
> (iii) the revenue needs of the deposit fund.'[24]

The FDIC has responded by using a risk-based classification system based on detailed reports and expert evaluations of the financial condition of an institution. The FDIC's regulations require the agency to analyse objective 'capital' factors as well as subjective 'supervisory' factors.[25] The capital factors determine the institution's 'capital group', signified as a 1, 2 or 3 in the risk classification. The supervisory risk factors determine the institution's 'supervisory sub-group', signified as an A, B, or C in the risk classification.[26] Further, the regulations provide that the FDIC will assign an institution a supervisory subgroup based on the FDIC's 'consideration of supervisory evaluations provided by the institution's primary federal regulator'.[27]

The US FDICIA 1991 approach demonstrates that the regulator can influence the risk preferences of the bank manager by adjusting the insurance premia rates for insured deposits. Despite the FDIC's new powers to devise premium charges that more truly reflect the underlying risk of a bank's assets, some experts argue that deposit insurance premia in the USA remain underpriced.[28] Nevertheless, regulators are in agreement that the reduction of moral hazard in bank risk-taking requires the efficient pricing of deposit insurance premia along with a level of coverage that creates an incentive for depositors to engage in an optimal level of monitoring and bearing some of the risks of bank managers.

Moral hazard — the lender of last resort, bank manager and fixed claimants

Moral hazard can also exist between the regulator and bank manager. The issue that arises is whether the regulator can design governance structures to reduce the social costs of bank risk-taking. According to Arrow,[29] it is impossible to allocate risk efficiently between the regulator and bank because of asymmetric information. For instance, the lender of last resort (LOLR) mechanism provides a safety net that allows the bank to shift risk to the regulator (insurer) or to depositors. This is especially the case when the bank is perceived as too big to fail. The LOLR mechanism provides a safety net for banks that allows them to discount the cost of their risk-taking. On the other hand, in regard to deposit insurance, it has been argued that the insurer-regulator is assumed to manage the trade off between the social costs of bank default and the economic benefits of bank risk-taking when the bank avoids default.[30]

Moreover, various devices are used to protect fixed claimants against excessive risk-taking in the firm. However, according to Macey *et al.*,[31] what makes banks

primarily different from other types of firms is the lack of discipline exerted by fixed claimants (eg depositors and other banks). According to Hellmann *et al.*,[32] monitoring financial institutions is a public good, which will give rise to a free rider problem. For example, deposit insurance reduces the incentive for insured depositors to monitor the bank's risk-taking because their deposits are protected regardless of the success of the banks' investments. Furthermore, in a world without deposit insurance, depositors would be incentivised to demand a higher interest rate to compensate for the extra risk due to the bank's risk-taking. This would increase the cost of capital in the banking sector and thus inhibit economic development objectives. Therefore, it is necessary that the regulator play an appropriate role in designing an incentive compatible deposit insurance system and to address other sources of market failure.

REGULATORY INTERVENTION

The foregoing illustrates the wide range of potential agency problems in financial institutions involving several major stakeholder groups including, but not limited to, shareholders, creditors/owners, depositors, management, and supervisory bodies. Agency problems arise because responsibility for decision making is directly or indirectly delegated from one stakeholder group to another in situations where objectives between stakeholder groups differ and where complete information which would allow further control to be exerted over the decision maker is not readily available. One of the most studied agency problems in the case of financial institutions involves depositors and shareholders, or supervisors and shareholders. While that perspective underpins the major features of the design of regulatory structures — capital adequacy requirements, deposit insurance, etc — incentive problems that arise because of the conflicts between management and owners have become a focus of recent attention.[33]

The resulting view, that financial markets can be subject to inherent instability, induces governments to intervene to provide depositor protection in some form or other. Explicit deposit insurance is one approach, while an explicit or implicit deposit guarantee is another. In either case, general prudential supervision also occurs to limit the risk incurred by insurers or guarantors. To control the incentives of bank owners who rely too heavily on government-funded deposit insurance, governments typically enforce some control over bank owners. These can involve limits on the range of activities; linking deposit insurance premiums to risk; and aligning capital adequacy requirements to business risk.[34]

While such controls may overcome the agency problem between government and bank owners, it must be asked how significant this problem is in reality. A cursory review of recent banking crises would suggest that many causes for concern relate to management decisions which reflect agency problems involving management. Management may have different risk preferences from those of other stakeholders including the government, owners, creditors, etc, or limited competence in assessing the risks involved in its decisions, and yet have significant freedom of action because of the absence of adequate control systems able to resolve agency problems.

Another important area that has not attracted sufficient academic or regulatory attention concerns the issues of whether to regulate the financial compensation provided by banks to their employees and shareholders. Indeed, the risk-taking strategies of senior management and directors are significantly influenced by their compensation arrangements and by their exposure to civil and criminal liability for their risk-taking practices. The goal should be

aligning the incentives of shareholders, depositors and creditors. In other words, they must be required to incur the costs of their risk-taking activities. The regulator can only hope to approximate this in the real world. What has become generally recognised, however, is that regulators should be given broad statutory authority to exercise discretion in assessing the risk profile of a particular institution and to respond rapidly to developments in financial markets that affect risk-taking. For instance, this might involve controlling incentive arrangements for certain key personnel in the bank who exercise control over the bank's leverage positions.

In addition, a significant tool for the regulator in ensuring that its regulatory standards are met is the use of administrative penalties and civil sanctions on banks or their directors and employees for taking actions in breach of regulation. Effective regulatory intervention requires that regulators have the resources and discretion to bring enforcement actions for alleged breach. Such discretion could include fact finding in administrative hearings which can only be reviewed on judicial review on the basis of abuse of discretion or based on substantial facts. This type of discretion, however, can be criticised on the grounds that it places too much power in the hands of the regulator to act in a way that some might view to be arbitrary and capricious. Indeed, the discretionary power of the regulator may result in discriminatory treatment between banks or individuals that might violate human rights legislation. Moreover, it might violate a person's right to have civil penalties or sanctions reviewed by a fair and impartial tribunal.[35]

INTERNATIONAL INITIATIVES

International standards of banking regulation traditionally relied on compliance with external standards or criteria of assessment (eg 8 per cent capital adequacy) to determine the safety and soundness of banks, but with the adoption of Basel II there has been a change in emphasis that focuses on whether a bank's internal processes and decision-making structure complies with procedural standards of assessment. Banks are expected to follow process-oriented rules in assessing the risk of assets and calculating capital and not merely relying on external standards and criteria of assessment. This involves the regulator working closely with banks and adjusting standards to suit the particular risk profile of individual banks. Indeed, Basel II emphasises that banks and financial firms should adopt, under the general supervision of the regulator, internal self-monitoring systems and processes that comply with statutory and regulatory standards. Pillar II of Basel II provides for supervisory review that allows regulators to use their discretion in applying regulatory standards. This means that regulators have discretion to modify capital requirements depending on the risk profile of the bank in question. Also, the regulator may require different internal governance frameworks for banks and to set controls on ownership and asset classifications.

OECD and Basel Committee

In its most recent corporate governance report, the OECD emphasised the important role that banking and financial supervision plays in developing corporate-governance standards for financial institutions.[36] Consequently, banking supervisors have a strong interest in ensuring effective corporate governance at every banking organisation. Supervisory experience underscores the necessity of having appropriate levels of accountability and managerial competence within each bank. Essentially, the effective supervision of the international banking system requires sound governance structures within each bank, especially with respect to multi-functional banks that oper-

ate on a transnational basis. A sound governance system can contribute to a collaborative working relationship between bank supervisors and bank management.

The Basel Committee on Banking Supervision (Basel Committee) has also addressed the issue of corporate governance of banks and multinational financial conglomerates, and has issued several reports addressing specific topics on corporate governance and banking activities.[37] These reports set forth the essential strategies and techniques for the sound corporate governance of financial institutions, which can be summarised as follows:

— '[e]stablishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation';[38]
— '[s]etting and enforcing clear lines of responsibility and accountability throughout the organisation';[39]
— '[e]nsuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns';[40]
— '[e]nsuring that there is appropriate oversight by senior management';[41]
— '[e]ffectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide';[42]
— '[e]nsuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment';[43] and
— '[c]onducting corporate governance in a transparent manner'.[44]

These standards recognise that senior management is an integral component of the corporate-governance process, while the board of directors provides checks and balances to senior managers, and that senior managers should assume the oversight role with respect to line managers in specific business areas and activities. The effectiveness of the audit process can be enhanced by recognising the importance and independence of the auditors and requiring management's timely correction of problems identified by auditors. The organisational structure of the board and management should be transparent, with clearly identifiable lines of communication and responsibility for decision-making and business areas. Moreover, there should be itemisation of the nature and the extent of transactions with affiliates and related parties.[45]

Basel II

The New Basel Capital Accord (Basel II)[46] contains the first detailed framework of rules and standards that supervisors can apply to the practices of senior management and the board for banking groups. Bank supervisors will now have the discretion to approve a variety of corporate governance and risk management activities for internal processes and decision making, as well as substantive requirements for estimating capital adequacy and a disclosure framework for investors. For example, under Pillar One, the board and senior management have responsibility for overseeing and approving the capital rating and estimation processes.[47] Senior management is expected to have a thorough understanding of the design and operation of the bank's capital rating system and its evaluation of credit, market, and operational risks.[48] Members of senior management will be expected to oversee any testing processes that evaluate the bank's compliance with capital adequacy requirements and its overall control environment. Senior management and executive members of the board should be in a position to justify any material differences between established procedures set by regulation and

actual practice.[49] Moreover, the reporting process to senior management should provide a detailed account of the bank's internal ratings-based approach for determining capital adequacy.[50]

Pillar One has been criticised as allowing large, sophisticated banks to use their own internal ratings methodologies for assessing credit and market risk to calculate their capital requirements.[51] This approach relies primarily on historical data that may be subject to sophisticated applications that might not accurately reflect the bank's true risk exposure, and it may also fail to take account of events that could not be foreseen by past data. Moreover, by allowing banks to use their own calculations to obtain regulatory capital levels, the capital can be criticised as being potentially incentive-incompatible.

Pillar Two seeks to address this problem by providing for both internal and external monitoring of the bank's corporate governance and risk-management practices.[52] Banks are required to monitor their assessments of financial risks and to apply capital charges in a way that most closely approximates the bank's business risk exposure.[53] Significantly, the supervisor is now expected to play a proactive role in this process by reviewing and assessing the bank's ability to monitor and comply with regulatory capital requirements. Supervisors and bank management are expected to engage in an ongoing dialogue regarding the most appropriate internal control processes and risk-assessment systems, which may vary between banks depending on their organisational structure, business practices, and domestic regulatory framework.

Pillar Three also addresses corporate governance concerns by focusing on transparency and market-discipline mechanisms to improve the flow of information between bank management and investors.[54] The goal is to align regulatory objectives with the bank's incentives to make profits for its shareholders. Pillar Three seeks to do this by improving reporting requirements for bank capital adequacy. This covers both quantitative and qualitative disclosure requirements for both overall capital adequacy and capital allocation based on credit risk, market risk, operational risk, and interest rate risks.[55]

Pillar Three sets forth important proposals to improve transparency by linking regulatory capital levels with the quality of disclosure.[56] This means that banks will have incentives to improve their internal controls, systems operations, and overall risk-management practices if they improve the quality of the information regarding the bank's risk exposure and management practices. Under this approach, shareholders would possess more and better information with which to make decisions about well-managed and poorly managed banks. The downside of this approach is that, in countries with undeveloped accounting and corporate-governance frameworks, the disclosure of such information might lead to volatilities that might undermine financial stability by causing a bank run or failure that might not have otherwise occurred had the information been disclosed in a more sensitive manner. Pillar Three has not yet provided a useful framework for regulators and bank management to coordinate their efforts in the release of information that might create a volatile response in the market.

Although the Basel Committee has recognised that 'primary responsibility for good corporate governance rests with boards of directors and senior management of banks',[57] its 1999 report on corporate governance suggested other ways to promote corporate governance, including laws and regulations; disclosure and listing requirements by securities regulators and stock exchanges; sound accounting and auditing standards as a basis for communicating to the board and senior manage-

ment; and voluntary adoption of industry principles by banking associations that agree on the publication of sound practices.[58]

In this respect, the role of legal issues is crucial for determining ways to improve corporate governance for financial institutions. There are several ways to help promote strong businesses and legal environments that support corporate governance and related supervisory activities. These include enforcing contracts, including those with service providers; clarifying supervisors' and senior management's governance roles; ensuring that corporations operate in an environment free from corruption and bribery; and aligning laws, regulations, and other measures with the interests of managers, employees, and shareholders.

These principles of corporate governance for financial institutions, as set forth by the OECD and the Basel Committee, have been influential in determining the shape and evolution of corporate-governance standards in many advanced economies and developing countries and, in particular, have been influential in establishing internal control systems and risk-management frameworks for banks and financial institutions. These standards of corporate governance are likely to become international in scope and to be implemented into the regulatory practices of the leading industrial states.

It should be noted, however, that international standards of corporate governance may result in different types and levels of systemic risk for different jurisdictions due to differences in business customs and practices and the differences in institutional and legal structures of national markets. Therefore, the adoption of international standards and principles of corporate governance should be accompanied by domestic regulations that prescribe specific rules and procedures for the governance of financial institutions, which address the national differences in political, economic, and legal systems.

Although international standards of corporate governance should respect diverse economic and legal systems, the overriding objective for all financial regulators is to encourage banks to devise regulatory controls and compliance programmes that require senior bank management and directors to adopt good regulatory practices approximating the economic risk exposure of the financial institution. Because different national markets must protect against different types of economic risk, there are no universally correct answers accounting for differences in financial markets, and laws need not be uniform from country to country. Recognising this, sound governance practices for banking organisations can take place according to different forms that suit the economic and legal structure of a particular jurisdiction.

Nevertheless, the organisational structure of any bank or securities firm should include four forms of oversight: oversight by the board of directors or supervisory board; oversight by non-executive individuals who are not involved in the day-to-day management of the business; oversight by direct line supervision of different business areas; and oversight by independent risk management and audit functions. Regulators should also utilise approximate criteria to ensure that key personnel meet fit and proper standards. These principles should also apply to government-owned banks, but with the recognition that government ownership may often mean different strategies and objectives for the bank.

UK CORPORATE GOVERNANCE AND BANKING REGULATION

Duties of directors

Although the traditional model of UK corporate governance focuses on shareholder

wealth maximisation, it should be noted that English company law has traditionally stated that directors owe a duty to the company, not to *individual shareholders*.[59] This position has been interpreted as meaning that directors owe duties of care and fiduciary duties directly to the shareholders *collectively* in the form of the company, and not to the shareholders *individually*.[60] In essence, a director owes duties to the company and not to individual shareholders.[61]

In the case of bank directors, English courts have addressed the duties and responsibilities of senior management and directors over the affairs of a bank. The classic statement of directors' duties regarding a bank was in the *Marquis of Bute's Case*.[62] The Marquis had inherited the office of president of the Cardiff Savings Bank when he was six months old.[63] Over the next 38 years, he attended only one board meeting of the bank before he was sued for negligence in failing to keep himself informed about the bank's reckless lending activities. The judge rejected the liability claim on the grounds that, as a director, the Marquis knew nothing about the affairs of the bank and furthermore had no duty to keep himself informed of the bank's affairs.[64] In reaching its decision, the court did not apply a reasonable person standard to determine whether the Marquis should have kept himself informed about the bank's activities.

The case stands for the proposition that a 'reasonable person' test would not be applied to acts or omissions of a director or senior manager who had failed to keep himself informed of the bank or company's activities. In subsequent cases, the courts were reluctant to apply such a lenient liability standard. In *Dovey v Cory*[65] a third party brought an action in negligence against a company director for malpractice and the court applied a reasonable person standard in finding the director not liable.[66] The court found that the director had not acted negligently in receiving suspicious information from other company officers and in failing to investigate any further irregularities in company practice.[67] The significance of the case, however, was that the court recognised that a reasonable person test should be applied to determine whether a director had breached its duty of care and skill. But the reasonable person test would not be that of a 'reasonable professional director' — rather, it would be that of a reasonable man who had possessed the particular ability and skills of the actual defendant in the case.[68] If we were to apply this reasonable person standard to the *Marquis of Bute* case, it would have been difficult to impose liability on the Marquis for breach of duty because he would not have possessed the requisite skills to make an informed judgment, and therefore could have avoided liability on the grounds that he had no training or knowledge regarding how to manage a bank.[69] In contrast, based on the ruling in *Dovey v Cory*, it would have been easier to impose liability on an experienced and skilled senior manager who had failed to act on information that was of direct relevance to the company's operations. In the limited circumstances that liability could be demonstrated, the remedy would be damages.[70]

Based on the above, the legal framework for holding directors and senior managers liable for breach of duty under English law provided limited redress for shareholders seeking to recover damages for negligent management of a financial institution. Shareholders were required to establish that the defendant board member/senior manager possessed particular skills and that those skills were not exercised appropriately in discharging the management function. The difficulties in bringing an action for breach of duty led UK policy makers to devise a regulatory regime that allowed both shareholders and regulators to hold managers and board members directly

accountable for breach of a regulatory standard regardless of the skills, knowledge or training of the defendant. This liability regime is set forth in the UK Financial Services and Markets Act 2000 and the Financial Services Authority's regulatory regime.

The Financial Services and Markets Act: The statutory framework

The Financial Services and Markets Act 2000 (FSMA)[71] and its accompanying regulations create a regime founded on a risk-based approach to the regulation of all financial business. FSMA's stated statutory objectives are to maintain confidence in the financial system, to promote public awareness, to provide 'appropriate' consumer protection, and to reduce financial crime.[72] FSMA created the Financial Services Authority (FSA) as a single regulator of the financial services industry with responsibility, *inter alia*, for banking supervision and regulation of the investment services and insurance industries.[73]

To achieve these objectives, the FSA has been delegated legislative authority to adopt rules and standards to ensure that the statutory objectives are implemented and enforced.[74] The FSA has established a regulatory regime that emphasises *ex ante* preventative strategies, including front-end intervention when market participants are suspected of not complying with their obligations. Under the FSMA framework, regulatory resources are redirected away from reactive, post-event intervention towards a more proactive stance emphasising the use of regulatory investigations and enforcement actions, which have the overall objective of achieving market confidence and investor and consumer protection.

The FSA's main functions will be forming policy and setting regulation standards and rules (including the authorisation of firms); approval and registration of senior management and key personnel; investigation, enforcement and discipline; consumer relations; and banking and financial supervision. The FSMA requires the FSA to adopt a flexible and differentiated risk-based approach to setting standards and supervising banks and financial firms. The FSA has authority to enter into negotiations with foreign regulators and governments regarding a host of issues, including agreements for the exchange of information, coordinating implementation of EU and international standards, and cross-border enforcement and surveillance of transnational financial institutions.

The FSA's corporate governance regime

A major consequence of FSMA is its direct impact on corporate governance standards for UK financial firms through its requirement of high standards of conduct for senior managers and key personnel of regulated financial institutions. The main idea is based on the belief that transparency of information is integrally related to accountability in that it can provide government supervisors, bank owners, creditors, and other market participants sufficient information and incentive to assess a bank's management. To this end, the FSA has adopted comprehensive regulations that create civil liability for senior managers and directors for breaches by their firms, even if they had no direct knowledge or involvement in the breach or violation itself. For example, if the regulator finds that a firm has breached rules because of the actions of a rogue employee who has conducted unauthorised trades or stolen client money, the regulator may take action against senior management for failing to have adequate procedures in place to prevent this from happening.

High-level principles

The FSA has incorporated the eleven high-level principles of business that were part of previous UK financial services legislation.[75] They applied to all persons and

firms in the UK financial services industry. These principles also apply to senior management and directors of UK financial firms. The most widely invoked of these principles are integrity; skill, care, and diligence; management and control; financial prudence; market conduct; conflicts of interests; and relations with regulators. FSA regulations often cite these principles as a policy basis justifying new regulatory rules and standards for the financial sector. These principles are also used as a basis to evaluate the suitability of applicants to become approved persons to carry on financial business in the UK.

Principle Two states that '[a] firm must conduct its business with due skill, care and diligence'.[76] The FSA interprets this principle as setting forth an objective, reasonable person standard for all persons involved in the management and direction of authorised financial firms.[77] The reasonable person standard also applies to Principle Nine, which provides a basic framework for internal standards of corporate governance by requiring that a financial firm 'organise and control its internal affairs in a responsible manner'.[78] Regarding employees or agents, the firm 'should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures'.[79]

In addition, the FSA has adopted its own statement of principles for all approved persons, which includes integrity in carrying out functions,[80] acting with due skill and care in carrying out a controlled function,[81] observing proper standards of market conduct,[82] and dealing with the regulator in an open and honest way.[83] The FSA has also adopted additional principles that apply directly to senior managers and require them to take reasonable steps to ensure that the regulated business of their firm is organised so that it can be controlled effectively.[84] The objective, reasonable person test is reinforced in Principle Six with the requirement that senior managers 'exercise due skill, care and diligence in managing the [regulated] business' of their firm.[85] Additionally, senior managers must take reasonable steps to ensure that the regulated business of their firm complies with all applicable requirements.[86] These high-level principles demonstrate that an objective regulatory standard of care exists to govern the actions of senior managers and directors in their supervision and oversight of the banking firm.

Authorisation

FSMA s. 56 provides the legal basis for authorising financial firms and individuals.[87] Based on this authority, the FSA provides a single authorisation regime for all firms and approved individuals who exercise controlled functions in the financial services industry. The FSA can impose a single prohibition on anyone who is not an authorised or exempt person from carrying on regulated activities.[88] Any person who does so can be subject to civil fines and may be adjudicated guilty of a criminal offence.[89] The FSA takes the view that its authorisation process is a fundamental part of its risk-based approach to regulation.

The FSA discharges its function by scrutinising, at entry level, firms and individuals who satisfy the necessary criteria (including honesty, competence, and financial soundness) to engage in regulated activity. The authorisation process of the FSA regulations seeks to prevent most regulatory problems by maintaining a thorough vetting system for those seeking licences to operate or work in the financial sector.[90] The FSA has discretionary authority to exercise its powers in any way that it 'considers most appropriate for the purpose of meeting [its regulatory] objectives'.[91]

The FSA will take three factors into account when determining fitness and propriety in the authorisation process. First, it must make a determination that the applicant is honest in its dealings with consumers, professional market participants, and regulators.[92] This is known as the 'honesty, integrity, and reputation' requirement. Secondly, the FSA requires the applicant to have competence and capability — that is, the necessary skills to fulfil the functions that are assigned or expected.[93] Thirdly, an applicant must be able to demonstrate financial soundness.[94] These are objective standards that must be fulfilled to engage in the banking or financial business.

In addition, a firm or an individual applying for authorisation must submit a business plan detailing its intended activities, with a level of detail appropriate for the level of risks.[95] The FSA will determine whether employees, the company board, and the firm itself meet the minimum requirements set out in the Act. It is a core function of the FSA authorisation process that the regulator satisfy itself that the applicants and their employees are capable of identifying, managing, and controlling various financial risks and can perform effectively the risk-management functions.

Senior management arrangements, systems and controls

The FSMA aims to regulate the activities of individuals who exert significant influence on the conduct of a firm's affairs in relation to its regulated activities. Pursuant to this authority, the FSA has divided these individuals into two groups: members of governing bodies of firms, such as directors, members of managing groups of partners, and management committees, who have responsibility for setting the firm's business strategy, regulatory climate, and ethical standards; and members of senior management to whom the firm's governing body has made significant delegation of controlled functions.[96] Controlled functions include, *inter alia*, internal audits, risk management, leadership of significant business units, and compliance responsibilities.[97] The delegation of controlled functions likely would occur in a number of contexts, but would occur particularly in companies that are part of complex financial groups.

The FSA is required to regulate in a way that recognises senior managements' responsibility to manage firms and to ensure the firms' compliance with regulatory requirements. FSA regulations are designed to reinforce effective senior management and internal systems of control. At a fundamental level, firms are required to 'take reasonable care to establish and maintain such systems and controls as are appropriate to [their] business'.[98] The FSA requires senior management to play the main role in ensuring that effective governance structures are in place, overseeing the operation of systems and controls, and maintaining strong standards of accountability.[99]

More specifically, the FSA requires firms to take reasonable care to establish and maintain an appropriate apportionment of responsibilities among directors and senior managers in a way that makes their responsibilities clear.[100] They also are required to take reasonable care to ensure that internal governance systems are appropriate to the scale, nature, and complexity of the firm's business.[101] This reasonable care standard also applies to the board of directors and corporate officers who must exercise the necessary skill and care to ensure that effective systems and controls for compliance are in place. Unlike the reasonable care standard at common law, the reasonable care standard in the FSA regulations is an objective standard that expects corporate officers and board members to comply with a certain skill level when exercising

their functions. It will not be a defence for them merely to claim ignorance or lack of expertise if they fail to live up to the objective standard of care that requires them to establish and to maintain systems and controls appropriate to the scale, nature, and complexity of the business.[102]

Furthermore, a company's most senior executives, alone or with other senior executives from different companies in the same corporate group, are required to apportion senior management responsibilities according to function and capability, and to oversee the establishment and maintenance of the firm's systems and controls.[103] Corporate officers' and directors' failure to act reasonably in apportioning responsibilities may result in substantial civil sanctions and, in some cases, restitution orders to shareholders for any losses arising from these breaches of duty.[104] In addition to shareholders' private remedies for restitution, the FSA may impose additional and unlimited civil sanctions and penalties on individuals who are officers or directors in an amount that the FSA deems appropriate, even though the individuals in question may not have been involved directly in the offence in question.[105] The decision to impose personal liability can arise from the senior manager's failure to comply with the objective standard of care.

The FSA regulations for internal systems and controls address the problem, which existed at common law and in the Companies Act, of requiring only a subjective, reasonable person test to determine whether a board member met his or her duty of care and skill. Firms and their senior managers and officers are now required to comply with a heightened objective standard set by the FSA through its authorisation process or enforcement rules. For example, if a senior manager has exercised a controlled function in violation of the regulatory rules, and the FSA finds the manager to be in contravention of his or her legal obligations, the FSA may impose 'a penalty, in respect of the contravention, of such amount as it considers appropriate'.[106]

The regulations seek to ensure that the firm's system and control requirements will be proportionate to the size and nature of the firm's business. Moreover, corporate officers and directors of a bank or financial firm also have the responsibility to ensure that compliance with these systems and controls is linked in a meaningful way to the authorisation process.

The FSA has undertaken a number of enforcement actions to enforce these standards and to impose sanctions on senior managers for failing to act reasonably in maintaining internal controls and reporting wrongdoing by lower level employees. In the *Credit Suisse Financial Products* case,[107] the FSA disciplined three senior managers of Credit Suisse Financial Products (CSFP, now Credit Suisse First Boston). Two were disciplined for inappropriate conduct and the other one (the former chief executive) was disciplined for failing to implement the appropriate system of internal controls.[108] The FSA imposed a fine of £150,000 on the former CEO for failing to detect or prevent attempts to mislead the Japanese tax authorities in an audit of the firm's Japanese operations.

Although the FSA found that the CEO had properly delegated responsibility for complying with the firm's audit to other managers who had failed to execute their delegated function, it held nonetheless that the CEO was liable and thus subject to sanctions. Specifically, the FSA held that the CEO had failed to monitor and supervise staff, and to discern and investigate and to take preventative measures after it became apparent that the firm's employees were engaged in illegal conduct under Japanese law.[109] The FSA's case rested on the fact that the CEO had received documents that

would have provided him with the necessary information to discover the employees' misconduct had he read the documents. By failing to read the documents the CEO had violated the reasonable person standard for a person in his position, which prevented him from becoming aware of the misconduct which he agreed was inappropriate and illegal. The enforcement action shows how the FSA might act under the FSMA regime were a senior manager to breach the reasonable expectations of the FSA regulatory standards. Moreover, the case reveals the extraterritorial extent of the FSA's regulatory regime and how it can impose civil sanctions on financial market professionals for misconduct that takes place in other jurisdictions.

The UK FSA regulates UK banks and credit institutions and has devised prudential supervisory and regulatory standards to enhance the corporate governance frameworks of UK banks and financial institutions. These standards seek to address the principal-agent problem through: enhanced monitoring; improved disclosure and accounting practices; better enforcement of corporate governance rules and the corporate governance framework; and strengthening of institutions through market discipline. They also require banks to establish internal compliance programmes to monitor other types of risk arising from the growing problem of financial crime.

UK financial policy recognises the importance of authorising the financial regulator to balance these interests to protect the safety and soundness of the financial system and to promote economic growth and development. In contrast, US banking regulation adopts a more prescriptive approach in which the regulator applies more precise and uniform criteria for assessing the safety and soundness of a banking institution. The regulator is concerned not only with financial stability but with vindicating the rights of creditors and depositors to the extent that it protects the deposit insurance fund. US banking law and regulation, however, has made significant strides in adopting standards and rules that seek to reduce the principal-agent problem within the corporate group of banks.

It is submitted that this model of corporate governance that relies on the regulator playing a key role in devising governance standards and ensuring that senior management and directors comply with their duties is an important development in the regulation of financial markets. In the past, however, many regulators have played a passive role and not engaged with financial institutions in devising corporate governance structures that fit the risk profile of a banking institution. The globalisation of financial markets and increasing financial fragility in many financial systems necessitates a more proactive role by regulators in monitoring and evaluating the risk profile of financial institutions. The Basel II framework suggests that regulators engage more with banks in devising corporate governance standards. UK financial law and regulation has moved in this direction.

CONCLUSION

This paper suggests that bank regulation should seek to balance the interests of shareholders with management creditors, depositors, and other stakeholder interests in order to achieve the overall objective of financial stability. Specifically, the regulator has the primary role to play in devising standards of corporate governance for banks and financial institutions because of the externality risk that banks pose to the broader economy and the unique role of the regulator in assessing and managing bank risk-taking. An efficient corporate governance framework should rely less on a strict application of statutory codes and regulatory standards, and more on the

design of flexible, internal compliance programmes that fit the particular risk level and nature of the bank's business. To accomplish this, the regulator should play an active role with bank management in designing internal control systems and risk management practices that seek to achieve an optimal level of protection for shareholders, creditors, customers, and the broader economy. The regulator essentially steps into the shoes of these various stakeholder groups to assert stakeholder interests while ensuring that the bank's governance practices do not undermine the broader goals of macroeconomic growth and financial stability. The proactive role of the regulator is considered necessary because of the special risk that banks and financial firms pose to the broader economy.

It would be too extreme to describe financial regulation as a substitute for corporate governance practices — it would be more accurate to describe its role as reducing the collective-action problem in representing broader stakeholder interests in the economy to ensure that adequate governance standards are adopted to mitigate the social costs of bank risk-taking. Basel II represents a major change in the practice of regulation that involves regulators working with financial institutions to apply standards to bank risk-taking activity that reflects the particular risk profile of the bank. The UK FSA regulatory regime provides a comprehensive framework of corporate governance that recognises the important role played by the regulator in balancing the main stakeholder interests. The regulator enforces corporate governance standards by applying a reasonable person standard to determine whether the actions of managers and key persons comply with FSA regulatory requirements. Moreover, an important aspect of UK bank regulation involves its recognition of the relationship between the internal governance framework of banks and the incentive structure for risk-taking. This means the regulator must be diligent in overseeing compliance and possess the resources to enforce standards by imposing sanctions and allowing various stakeholders to seek legal redress.

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(2) Briault, C. (1999) 'The Rationale for a Single National Financial Services Regulator', Occasional Paper Series 2, May, Financial Services Authority, p. 7; Dewatripont, M. and Tirole, J. (1994) 'The Prudential Regulation of Banks', MIT Press, Cambridge, MA; Norton, J.J. (1995) 'Devising International Bank Supervisory Standards', Kluwer, Dordrecht, The Netherlands.

(3) Eatwell, J. and Taylor, L. (2000) 'Global Finance at Risk', Polity Press, Cambridge, UK.

(4) Underpriced financial assets can result in imprudent lending and trading activity for banks and lead to increased solvency risks. See Dewatripont and Tirole, ref. 2 above, pp. 23–25. Moreover, the difference between the private costs and the social costs of bank risk-taking is the negative externality imposed on society via depositors, borrowers and other banks.

(5) The social cost of bank risk-taking can take the form of a general loss of confidence by depositors in the banking sector (bank run) which will force banks to sell off their assets at prices far below their historic costs. Also, a defaulting bank's uninsured liabilities to other banks or financial institutions can serve as a source of contagion that can create substantial losses for other banks whose unfunded exposures to counterparties derive from

the original defaulting bank. Bank risk-taking therefore creates a negative externality for the broader economy that provides the major rationale for banking regulation. See Banking, Finance and Money.

(6) Dow, J. (2000) 'What is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation', *Monetary and Economic Studies*, Vol. 21, pp. 1–24.

(7) Goodhart, C.A.E., Hartmann, P., Llewellyn, D., Rojas-Suarez, L. and Weisbrod, S. (1988) 'Financial Regulation: Why, How and Where Now?', Routledge, London, UK.

(8) See Hawkins, J. and Turner, P. (2000) 'Managing Foreign Debt and Liquidity Risks in Emerging Economies: An Overview', BIS Policy Papers, September, pp. 8–9; http://www.bis.org/publ/plcy08

(9) Basel Committee on Banking Supervision (1999) 'Enhancing Corporate Governance for Banking Organizations', Bank for International Settlements (BIS).

(10) For instance, while workers know the level of effort they are putting into their jobs, the employer may be unable to observe how hard they are working. This means that workers may shirk their duties rather than work as hard as their employers may wish.

(11) Stiglitz, J. (1989) 'Principal and Agent' in J. Eatwell, M. Milgate and P. Newman (eds), 'The New Palgrave: Allocation, Information and Markets', Macmillan Press, Basingstoke, p. 241.

(12) Allen, F. and Gale, D. (1997) 'Comparing Financial Systems', pp. 93–97.

(13) Does the manager have better information? Perhaps the best evidence that monitors possess inferior information relative to managers lies in the fact that monitors often employ incentive mechanisms rather than relying completely on explicit directives alone. For example, such incentive mechanisms may take the form of tying a portion of a manager's compensation to the company performance in the stock market through the use of stock options.

(14) Stiglitz, J. E. (1987) 'The Causes and Consequences of the Dependence of Quality on Price', *Journal of Economic Literature*, Vol. 25, No. 1, p. 6.

(15) *Ibid.*, p. 3, 18. Overall, the presence of asymmetric information can prevent certain equilibrium outcomes from being achieved, and the market equilibria that often result fail to be Pareto optimal, showing the importance of perfect information for the efficient operation of financial markets and efficient management of financial firms.

(16) Stiglitz, J. E. and Weiss, A. (1981) 'Credit Rationing in Markets with Imperfect Information', *American Economic Review*, Vol. 71, pp. 393–394, 409.

(17) Flannery, M. and Ellis, D. (2002) 'Does the Debt Market Assess Large Banks' Risks?', *Journal of Monetary Economics*, December, pp. 481–502, 483–485.

(18) The Federal Deposit Insurance Corporation (FDIC) was established by statute during the Great Depression in 1931 to provide deposit insurance to the depositors of failed US banking institutions. During its first 60 years, it assessed the insured institutions at the same flat rate for deposit-insurance coverage. Although the FDIC was crucial for restoring depositor confidence in the US banking system following the 1940s and undoubtedly played a key role in the recapitalisation of US banks, it was criticised for creating moral hazard among bank managers and depositors who perceive respectively that they can be bailed out for making poor lending decisions and depositing money. See Kane, E.F. (1989) 'The S&L Insurance Mess: How Did it Happen?', Urban Institute Press, Washington, DC.

(19) Kane, ref. 18 above.

(20) *Ibid.*

(21) 57 Fed. Reg. 45263 (1st October, 1992).

(22) 58 Fed. Reg. 34357 (25th June, 1993).

(23) See 12 C.F.R. § 327. The transition regulations were in effect from 1st January, 1993 to 1st January, 1994.

(24) 12 U.S.C. § 1817(b)(1)(C).

(25) *FDIC v Coushatta*, 930 F. 2d 122 (5th Cir.), cert. denied, 502 U.S. 857 (1991).
(26) 12 C.F.R. § 327.3 (e)(1).
(27) 12 C.F.R. § 327.3(e)(1)(ii).
(28) Flannery, M. (1991) 'Pricing Deposit Insurance when the Insurer Measures Bank Risk with Error', *Journal of Banking and Finance*, September, pp. 975–998.
(29) Arrow, K. (1965) 'Aspects of the Theory of Risk-Bearing', Aldine-Atherton, Chicago, IL.
(30) See ref 28 above, pp. 981–87.
(31) Macey et al. (2003) See ref. 1 above.
(32) See ref. 16 above.
(33) See Biais, B. and Pagano, M. (2002) 'New Research in Corporate Finance and Banking', Oxford, pp. 190–202 (discussing conflicts between shareholders and management).
(34) For details on attempts to align regulatory capital with economic risk, see Basel Committee on Banking Supervision (2001) 'Second Consultative Paper of the New Basel Accord', 16th January, http://www.bis.org/publ/bcbsca03.pdf (hereinafter Second Consultative Paper).
(35) See Art. 6(1) of the European Convention on Human Rights. See also *R (on the application of Fleurose) v Securities and Futures Authority Ltd* [2001] EWHC Admin 292 [2001] 2 All ER (Comm) 481.
(36) See Organization for Economic Cooperation and Development (OECD), Survey of Corporate Governance Developments in OECD Countries 12, http://www.oecd.org/dataoecd/58/27/21755678.pdf (2002) (noting that banks '[i]n several countries ... have had an important place in the overall corporate governance system, serving both a monitoring and a financial role').
(37) The most important of these reports are Basel Committee on Banking Supervision (2000) 'Principles for the Management of Credit Risk', http://www.bis.org/publ/bcbs125.pdf; Basel Committee on Banking Supervision (1998) 'Framework for Internal Control Systems in Banking Organisations', http://www.bis.org/publ/bcbs40.pdf; Basel Committee on Banking Supervision (1998) 'Enhancing Bank Transparency: Public Disclosure and Supervisory Information that Promote Safety and Soundness in Banking Systems', http://www.bis.org/ publ/bcbs41.pdf; and Basel Committee on Banking Supervision (1997) 'Principles for the Management of Interest Rate Risk', http://www.bis.org/publ/bcbs29a.pdf.
(38) Basel Committee on Banking Supervision (1999) 'Enhancing Corporate Governance for Banking Organisations 5', http://www.bis.org/publ./bcbs56.pdf (September).
(39) *Ibid.*
(40) *Ibid.* at p. 6.
(41) *Ibid.* at p. 7.
(42) *Ibid.*
(43) *Ibid.* at p. 8.
(44) *Ibid.*
(45) The International Accounting Standards Committee defines 'related parties' as parties who are able to exercise 'control' or 'significant influence'. Cairns, D. and Nobes, C. (2000) 'The Convergence Handbook: A Comparison Between International Accounting Standards and UK Financial Reporting Requirements 101', Institute of Chartered Accountants in England and Wales. Such controlled relationships include parent-subsidiary; entities under common control; associates; individuals who, through ownership, have significant influence over the enterprise, and close members of their families; and key management personnel.
(46) Basel Committee on Banking Supervision (2003) 'The New Basel Capital Accord (Consultative Document)', http://www.bis.org/publ.bcbsca03.pdf (April) [hereinafter Basel II]. See discussion in Ward, J. (2002) 'The supervisory approach: A critique', Working Paper No. 2, The Cambridge Endowment for Research in Finance, www.cerf.cam.ac.uk
(47) *Ibid.* at para. 400. Pillar One states, in relevant part, as follows: 'All material aspects of the rating and estimation processes must be approved by the bank's

board of directors or a designated committee thereof and senior management. These parties must possess a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports.'

(48) *Ibid.*

(49) *Ibid.* at para. 401.

(50) *Ibid.* at para. 402.

(51) See, eg, Ward, J. (2002) 'The new Basel accord and developing countries: Problems and alternatives', Working Paper No. 4, The Cambridge Endowment for Research in Finance, www.cerf.cam.ac.uk at p. 11 (describing Basel II's reliance on banks' own risk estimates as a 'fundamental weakness').

(52) See Basel II, ref. 46 above, at pp. 11–29 (discussing the supervisory review process).

(53) *Ibid.* at para. 680.

(54) *Ibid.* at paras. 758–59; Ward, ref. 51 above n. 116 (Working Paper No. 04), at p. 9.

(55) See Basel II, ref. 51 above, at pp. 22–27 (detailing both quantitative and qualitative disclosure enhancing requirements).

(56) See *ibid.* at para. 758 (explaining that '[t]he purpose of Pillar [Three] ... is to complement the minimum capital requirements [of Pillar One]').

(57) Basel Committee, ref. 38 above, at p. 10.

(58) *Ibid.*

(59) *Percival v Wright* [1902] 2 Ch 421, 425-26 (rejecting shareholders' demand that share sales be set aside on grounds that company chairman and directors breached duty owed to shareholders). See also *Re Chez Nico Ltd* [1992] BCLC 192 (1991) (stating that, 'in general directors do not owe fiduciary duties to shareholders but owe them to the company'). This principle applies only to those duties owed by directors to the company that arise out of their appointment as company directors. It would not apply for instance to directors' duties that arose from a special relationship between directors and shareholders based on particular facts. See discussion in Davies, P.L. (2003) 'Gower and Davies' Principles of Modern Company Law', 7th edn, Sweet and Maxwell, UK, pp. 374–75, and also Boyle, L., Potts QC. R. and Sealy, L.S. (1986) 'Gore-Browne on Companies', 44th edition, Jordan Publishing Ltd, s.12.17.

(60) Gower and Davies, ref. 59 above, p 374.

(61) This case has been actively criticised in New Zealand and Australia. The New South Wales Court of Appeal in *Brunninghausen v Glavanics* (1999) 32 ACSR 294 recently refused to follow the decision, thus following the lead taken by the New Zealand Court of Appeal in *Coleman v Myers* [1977] 2 NZLR 225. The law has now evolved to a point where the courts recognise that a fiduciary duty may be owed by directors to individual shareholders in special circumstances, such as where the company is a family-run business. See also *Peskin v Anderson* [2000] 2 BCLC 1 at p. 14 per Neuberger J and *Peskin v Anderson* (CA) [2001] 1 BCLC paras. 58–59. The judgments, both at first instance and in the Court of Appeal, agreed that special circumstances must be established, particularly in 'the specially strong context of the familial relationships of the directors and shareholders and their relative personal positions of influence in the company concerned'.

(62) *In Re Cardiff Savings Bank (Marquis of Bute's Case)* [1892] 2 Ch. 100.

(63) *Ibid.* p. 105.

(64) *Ibid.*

(65) [1901] AC 477.

(66) *Ibid.* pp. 492-493.

(67) *Ibid.*

(68) See *In Re City Equitable Fire Insurance Co. Ltd* [1925] 1 Ch. 407, 408 (stating that a director 'need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience').

(69) The Marquis became president of the bank when he was six months old. *In Re Cardiff Savings Bank* [1892] 2 Ch. P. 105.

(70) Regarding fiduciary duties, English company directors have the paramount

duty of acting *bona fide* in the interest of the company. Specifically, this means the director individually owes a duty of good faith to the company, which means the director is a fiduciary of the company's interest. Although the director's fiduciary duties resemble the duties of a trustee, they are not the same. These are discussed in Davies and Gower, ref. 59 above, *Company Law* p. 381. The fiduciary duties of directors have been set forth in the Companies Act and fall into the following categories: the directors may act only within the course and scope of duties conferred upon them by the company memorandum or articles, and they must act in good faith in respect to the best interest of the company, while not allowing their discretion to be limited in the decisions they make for the company. Moreover, a director who finds himself or herself in the position of having a conflict of interest will be required to take corrective measures. The remedy for breach of fiduciary duty is restitution or compensation for the value of the property dissipated or lost by the bank manager.

(71) The statute's title is the Financial Services and Markets Act 2000 c. 8 (Eng.) The FSMA received Royal Assent on 14th June, 2000. *Ibid.* The FSMA repealed existing financial services legislation, including the Banking Act of 1987, the Financial Services Act of 1986, and the Insurance Companies Act of 1982. Briault, C. (1999) ref. 2 above.

(72) 2000 c. 8 at s. 2. The UK Parliament adopted FSMA, in part, as a response to major financial scandals occurring in the 1990s that resulted in the collapse of the Bank of Credit and Commerce International and Barings. See generally Matyjewicz, G. and Blackburn, S. (2003) 'The Need for Corporate Governance', http://www.gapent.com/sox/corporate_governance.htm (May) (discussing high-profile scandals in the UK).

(73) Briault, ref. 2 above, at p. 5. The FSA has been described as a 'super-regulator' and as one of the largest and most powerful regulatory bodies in the world (*ibid.*). The FSA has been chartered by Parliament as a company limited by guarantee, which is accountable to the Treasury and funded by industry levies. 2000, c. 8 at s. 12.

(74) 2000, c. 8 at s. 2.4. In so doing, the FSA must have regard to seven principles, which include 'the desirability of facilitating innovation in connection with regulated activities'; 'the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions'; and 'the desirability of facilitating competition between those who are subject to any form of regulation by the Authority'. 2000, c. 8, s. 2.3.

(75) FSA, Press Release, 'The FSA Publishes Response Paper on Principles for Business', http://www.fsa.gov.uk/pubs/press/1999/099.html (12th October, 1999).

(76) *Ibid.*

(77) FSA, 'Statement of Principle and Code of Practice for Approved Persons § 4.2', http://www.fsa.gov.uk/handbook/legal_instruments/2001/nov15_aper.pdf (1st December, 2001) [hereinafter FSA Code of Practice].

(78) FSA, Press Release, 'Paine Webber International (UK) Limited Fined £350,000'.

(79) *Ibid.*

(80) FSA Code of Practice, ref. 70 above, at s. 4.1.1. Principle One states, 'An *approved person* must act with integrity in carrying out his *controlled function*' (emphasis in original).

(81) *Ibid.* at s. 4.2.1. Principle Two states, 'An *approved person* must act with due skill, care and diligence in carrying out his *controlled function*' (emphasis in original).

(82) *Ibid.* at s. 4.3.1. Principle Three states, 'An *approved person* must observe proper standards of market conduct in carrying out his *controlled function*' (emphasis in original).

(83) *Ibid.* at s. 4.4.1. Principle Four states, 'An *approved person* must deal with the FSA and with other regulators in an open and cooperative way and must disclose

appropriately any information of which the FSA would reasonably expect notice' (emphasis in original).

(84) *Ibid.* at s. 4.5.1. Principle Five states, 'An *approved person* performing a *significant influence function* must take reasonable steps to ensure that the business of the *firm* for which he is responsible in his *controlled function* is organised so that it can be controlled effectively.' Id. (emphasis in original).

(85) *Ibid.* at s. 4.6.1. Principle Six states, 'An *approved person* performing a *significant influence function* must exercise due skill, care and diligence in managing the business of the *firm* for which he is responsible in his *controlled function*' (emphasis in original).

(86) *Ibid.* at s. 4.7.1. Principle Seven states, 'An *approved person* performing *a significant influence function* must take reasonable steps to ensure that the business of the *firm* for which he is responsible in his *controlled function* complies with the relevant requirements and standards of the *regulatory system*' (emphasis in original).

(87) Section 56 states, in relevant part, as follows: '[I]f it appears to the [Financial Services] Authority that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person ... [t]he Authority may make an order ("a prohibition order") prohibiting the individual from performing a specified function, any function falling within a specified description or any function' (2000, c. 8 at s. 56).

(88) *Ibid.* at s. 56(2).

(89) *Ibid.* at s. 56(4).

(90) See *ibid.* at ss. 51–54 (setting forth provisions governing the authorisation process).

(91) *Ibid.* at s. 2(1)(b).

(92) FSA, 'FSA Handbook: Enforcement § 8.5.2(1)(a)', http://www.fsa.gov .uk/handbook/BL3ENFPP/ENF/Chapter_8.pdf (January 2004).

(93) *Ibid.* at s. 8.5.2(1)(b).

(94) *Ibid.* at s. 8.5.2(1)(c).

(95) FSA, 'FSA Handbook: Threshold Conditions § 2.4.6', http://www.fsa.gov.uk/handbook/BL1CONDpp/COND/Chapter_2.pdf (January 2004).

(96) FSA, 'Consultation Paper 26: The Regulation of Approved Persons, 4', http://www.fsa.gov.uk/pubs/cp/cp26.pdf (July 1999).

(97) FSA, 'FSA Handbook: Supervision § 10.4.5', http://www.fsa.gov.uk/handbook/BL3SUPppb/SUP/Chapter_10.pdf (January 2004).

(98) FSA,' FSA Handbook: Senior Management Arrangements, Systems and Controls § 3.1.1', http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_3.pdf (January 2004).

(99) *Ibid.* at s. 1.2.1 (available at http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/ Chapter_1.pdf).

(100) *Ibid.* at s. 2.1.1 (available at http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/ Chapter_2.pdf).

(101) *Ibid.* at s. 3.1.1. The original statement of this principle was set forth in the FSA's consultation on firms' senior management responsibilities. See FSA, Consultation Paper 35: Senior Management Arrangements, Systems and Controls 8, http://www.fsa.gov.uk/pubs/cp/cp35.pdf (December 1999) [hereinafter Consultation Paper 35].

(102) The defence of ignorance put forth by the Marquis of Bute, discussed in refs. 62–64 above and accompanying text, would not have been available under these regulations.

(103) Consultation Paper 35, ref. 101 above, at 10.

(104) See Financial Services and Markets Act 2000, c. 8 at s. 66 (allowing the FSA to impose penalty for failure to comply with a statement of principle); *ibid.* at s. 382 (authorising use of restitution orders).

(105) See *ibid.* at s. 66(2)(b) (defining misconduct to include the indirect act of being 'knowingly concerned' in an offence).

(106) *Ibid.* at s. 206(1).

(107) See FSA enforcement action at http://www.fsa.gov.uk/pubs/final/index-2002.html

(108) This case involved facts that occurred in 1996–97 before the FSA was established and therefore was subject to the Financial Services Act 1986 and to enforcement proceedings by the former self-regulatory body, the Securities and Futures Authority (SFA), for breach of High Level principles 5, 7 and 9. These principles today would be enforced under the FSA's 'Senior Management Arrangements, Systems and Controls' (SYSC).

(109) At the time, the FSA's fine was the largest it had ever imposed on an individual.

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