

***Financial and Banking Services Market***

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**CORPORATE GOVERNANCE
IN UKRAINIAN BANKING****Abstract**

The paper studies the topical problems of corporate governance in Ukrainian banking area. The notion of corporate governance and its role in banking business is defined. The state of corporate governance in the banks of Ukraine is analyzed. The necessity is substantiated to develop national principles of corporate governance in banking organizations, also to create the mechanism for risk rating related to poor corporate governance.

Key words:

Corporate governance, banking area, national principles of corporate governance, mechanism for risk rating, poor corporate governance.

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The transition of our national banking system to a higher quality stage is caused by urgency of the problems which either had not been known recently or were viewed in the context of familiarizing with international practice. Among the «problems of development» the corporate governance is of significant importance for national banks.

The problem of bank corporate management is urgent not only in Ukraine, but also in the industrially developed countries. There they began to discuss the named issue since the middle of the 1990-s. At that time the term «corporate governance» was in general associated with the company management. However, it is generally recognized that corporate management is a significant factor which produces effect on market value of a company's stock.

Though corporate governance is of great importance, the current theory and practice have not developed a standard definition of that notion. Thus, according to H. Mathiesen «corporate governance is an economic area, which studies how to provide effective management of a corporation» [1; 9]. A. Shleifer and R. Vishny consider that «corporate governance is an agreement between the investors and the corporations to confirm the first that their investments will be paid back.» [2; 737]. J. Wolfenson, President of the World Bank described the «corporate governance as improvement of corporate honesty, translucency and responsibility» [3]. According to the «Principles of OECD Corporate Governance» « the corporate governance is the internal instruments applied for managing and controlling the company's operation». [4; 2]. S. Kondo, Deputy Secretary-General of that organization defined corporate governance as «a group of behaviorist relations, which the enterprises are directed and controlled» [5]. The corporate normative act of the European Bank of Reconstruction and Development notes that corporate governance reveals « forms and possibilities for stockholders' control over activity of top managers and participation in key decision-making» [6; 5]. According to the Principles of Corporate Governance, enacted by the State Commission for Securities and Stock Market in Ukraine, corporate governance is «a system enabling to direct and control the activity of a body» [7; 4]. The named document says that «the matter of corporate governance is a system of relations between the investors and the owners of a company, its managers, and interested persons to ensure the efficient activity of a company, also effective equilibrium and balance of interests of corporate relations participants» [ibid].

As the analysis of the given definitions show, the list of the latter is not complete, the corporate governance could be interpreted in wide and narrow senses. Thus, corporate governance determines the distribution of authorities between the bodies of company's management, in other words, the organizational model through which the company realizes and protects the interests of its investors. On the other side, corporate governance is viewed as a system notion

which embraces not only inter-relations within the corporation, but also the relations of the latter with other interested people.

In our opinion, **corporate governance** is a system of relations among the owners, managerial bodies of a company, and its clients, employees, creditors, investors, and organs of power with the aim of ensuring the owners' welfare and the society as a whole. Our approach is grounded on understanding that the growth of the company's market value is possible not only under efficient management, sustained financial state, and reasonable strategy. The company's success primarily depends upon inter-relations with certain groups of interested individuals. Only under those conditions the suppliers of the resources would invest their funds into the company which could provide positive effect on all participants of corporate relations.

Consequently, the role of corporate governance consists in attracting attention of the society to the company's activity. Accordingly, the quality of corporate governance provides an important factor, which forms the value of the company. The quality of corporate governance implies the rate of honesty and openness of the managing procedures, the accordance of the latter with the interests of shareholders and other participants of corporate relations.

Banking business is a specific form of entrepreneurial activity. At the same time, the problem of asymmetric information among the participants of major corporate relations, i.e. owners, managers, depositors, creditors, and regulating organs enhances the corporate governance in banking organizations as against the non-financial sector of economy. It enabled the OECD in its «Principles of Corporate Governance» to give a separate definition of corporate governance for banking organizations as «a chain of relations between the company's managerial bodies, its shareholders and other interested parties. Also, corporate governance suggests a scheme for defining the objectives of a company, and determines the methods for achieving the set objectives and monitoring the activity of the company» [4; 8].

As the Basel Committee on banking Supervision notes, from the viewpoint of banking industry, the corporate governance includes a method under which business and individual institutes are governed by the Boards of Directors and Managing Executive Committees, who influence the banking organizations on how they:

- Determine corporate objectives (including distributing economic profits to the owners);
- Manage current bank operations;
- Take into consideration the interests of distinguished participants;
- Agree corporate activity and behavior with the expectation that the banks are reliable and secure, as well as they adhere to relevant laws and normative acts; and

- Protect the interests of depositors [8; 4].

The bank depositors and creditors who are the most vulnerable against «unfavorable choice» and «moral hazard» [9; 86] are secured by regulating organs primarily via such instruments as normative regulation, insurance of deposits, requirements to make the information public, etc. In present conditions the genesis in banking supervision is shown in shifting accents from state intervention towards measures taken by the banks themselves who are to create an effective management system. To quote A. Greenspan, Head of the Federal Reserve System of the USA «we have to pursue the policy, when a private counter-partnership control is viewed as the first defense line of secure and reliable banking system» [10; 3]. Similar understanding was also demonstrated in the recommendations of Basel Committee, in particular, in new standards of banking capital (BASEL II), and in its below documents referring corporate governance in banking sector: «Principles of Interest rate Risk Management», «Regulation on Internal Controlling Systems in Banking Organizations», «Intensification of Banking Transparency», «Principles of Credit Risk Management» [11; 3], as well as in the most recent document «Practical Guidance on Operational Risks Management and Control» enacted in 2003. The ideology of those documents consists in the fact that the function of regulation organs is to monitor risks, while relevant bodies of bank governance are managing bank risks.

With respect to corporate governance in banking sector of Ukraine, we should note, that the majority of owners and managers of national banks realize its significance for banking business. Therefore, it is important to be familiarized with the national principles of corporate governance. We should admit that general level of banking corporate management in our country is not high so far. In our opinion, the following key problems are dominating in that area:

1. Imperfect distribution of authorities among the banking management bodies.
2. Poor security of stockholders' rights.
3. Insufficient information openness on banking activity.

Among other challenges the banking governing bodies are facing, the most critical and unsolved one is interaction between the Supervisory Board and Managerial Executive Board. The authorities of those organs are defined in the bank statute, and could be delegated only under condition when they are written in the minutes of the body to which the authorities are delegated, alongside with the term of the latter to be in effect. In case when the authorities are delegated to a bank by the Supervisory Board, then according to the common principles of corporate governance, both the bank and the Supervisory Board are responsible for setting certain tasks before general meeting of shareholders.

In Ukraine the Bank Supervisory Boards have not yet got their proper functional role. In particular, many national banks, in particular, those of closed form of ownership, do not see any difference between the Supervisory Board and general meeting. Besides, the members of a Supervision Board are practic-

ing groundless intervening into the operational activity of a bank, picking the authorities of Managerial Board.

According to generally accepted standards of corporate governance, the basic principle of functioning of Supervisory Board is its independence. Therefore, the Ukrainian principles of corporate governance imply that the independent members should make at least 25% in the Board [7; 18]. In addition, according to international norms a part of the members should be physical persons. However, as the indices of the International Finance Corporation show, the Supervision Boards in half of Ukrainian banks consist of three or four people (see table 1), and only 30% of banks have one or several independent Board members [12; 12].

Table 1

**Committees within the Supervisory Board Structures
in Leading Banks of Developed Countries**

Banks	Audit Committee	Remuneration Committee	Nominating Committee	Risk Management Committee	Total
Bank of America	+	+	–	–	5
Deutsche Bank	+	–	+	+	4
HBOS	+	+	+	–	3
UBS	+	+	+	–	4
Credit Suisse	+	+	–	+	4
ABN AMRO	+		+	–	2

The absence of Committees within the structure of that body could be also explained by insignificant number of members in Supervisory Boards, though Ukrainian and International principles of corporate governance envisage the feasible formation of those structures, and recommend to make a post of corporate secretary in Supervisory Board [7; 20, 22]. Moreover, Basel Committee in Banking Supervision defines, that the Supervisory Boards should have not less than four Committees organized, in particular: Audit, Remuneration, Nominating, and Risk Management Committees [11; 6–7].

Apropos of that, we have examined six big banks on the subject of their Supervisory Boards structures on the basis of their web-site information. Proceeding from the analysis (see table 1), the Supervisory Banks in all the exam-

ined banks are incorporating separate Committees – from two in ABN AMRO, Netherlands to five in the Bank of America. All those banks have got the Audit Committees, and most of them have got separate Remuneration Committees. With respect to the functions of risk management, they could be distributed among several structures. Three of the examined banks, specifically the Bank of America, UBS, and Credit Suisse have the Corporate Governance Committees created.

The principle of the Supervisory Board independency is opposed by widely applied in national banks practice, when principal stockholders themselves appoint members of both the Board and Management Executive. Consequently, the latter are primarily operating for the sake of the stockholders against the bank as a whole. Thus, according to the data of International Financial Corporation the members of Supervisory Board in 38% of examined banks were representatives of three principal shareholders. In 64% of banks all the members of Supervisory Board were appointed by principal shareholders, and in 72% of banks the Board members are the banks' shareholders themselves [12; 36]. Proceeding from the analysis of educational and qualification characteristics of the members of Supervisory Boards in Ukrainian banks (see table 2) we can observe that the basic criterion for appointing the members of the Supervisory Board is not availability of «needed knowledge, skills and practice for performing functions» according to the required principles of corporate governance [7; 18], but faithfulness to principal shareholders.

Table 2

Membership Structure of Supervisory Boards in Ukrainian Banks [12; 36]

	Bank Organizational Legal Form			
	Joint-Stock	Closed Corporation	J.-Stock, Ltd.	Total
Average members of Advisory Board	5.63	4.55	3.00	5.18
Average members of Advisory Board with higher education in economics, law or management	3.75	1.63	2.00	3.24
Average members of Advisory Board with practical skills in financial area	1.60	1.45	0.75	1.50

While comparing the state of affairs in the Ukrainian banking management, we will see that the activity of the named governing body is the most formalized. The members of banking governance are usually elected in Ukraine by

principal shareholders or Head of the Board of Directors, and are confirmed by the Supervisory Board. As table 3 shows the available qualification characteristics of the members of Boards of Directors in Ukrainian Banks are fairly satisfactory. A greater concern provides the distribution of authorities between the Board of Directors and Advisory Board. For example, in 58% of Ukrainian banks the strategy and mission is developed by the Board of Directors, though it is the prerogative of the Supervisory Board.

Table 3

Membership Structure of Board of Directors Members in Ukrainian Banks
[12; 41]

	Bank Organizational Legal Form			
	Joint-Stock	Closed Corporation	J.-Stock, Ltd.	Total
Average members of Board of Directors	7.06	5.82	6.75	6.76
Average members of Board of Directors with higher education in economics, law or management	6.54	5.18	5.75	6.18
Average non-resident members of Board of Directors	0.06	0.18	0.25	0.10

In the area of protection the rights of shareholders a great attention of international and national principles of corporate governance is paid to the protection of so called petty shareholders. At the moment 82% of Ukrainian banks have petty shareholders [12; 15]. Most of those people traditionally did not pay money for the bank shares they own. Most often those shareholders happen to be the bank employees, who were offered the shares to concentrate the control over the bank or to optimize taxation. As a result, the general meetings in 22% of banks are attended by at least half of minor shareholders [12; 61]. The liquidity of Ukrainian bank shares is also low, though under the requirements of «New standards of banking capital» a bank has no right to show in its statement more than 70% of shares nominal value if it did not make a market at the stock exchange and the market value of the shares is unknown. At the moment only 56% of banks empower their shareholders to sell the shares on the off – exchange markets, 76% of bank shareholders can sell their shares to other shareholders, while 60% – to sell directly to the banks. At that, in 12% out of the latter the

shares were sold at market price, and in 64% of cases – at nominal price [ibid]. That approach proves that the banks are not interested in petty shareholders. Traditionally, it is demonstrated in widely applied practice of purchasing shares of small shareholders with the aim to concentrate capital.

The important task of corporate governance is to create information transparency referring the company's operation. In particular, it refers to banks, since their relations with clients are grounded on synergy. Therefore, making information public, in other words transparency is a problem of concern, primarily in the milieu of banking regulators. Proceeding from the recommendations of Basel Committee in Banking Supervision [13], the banks should make the information public with respect to the following:

- structure of Supervisory Board;
- structure of Board of Directors, including membership, qualification descriptions, structure;
- organizational structure of a bank;
- wage system and material incentives;
- matter and volume of operations related to individuals.

In Ukraine 76% of the banks under study publish their financial statements according to the International Accounting Standards [12; 53], though in most cases the transition of Ukrainian banks to International Accounting Standards had been made only meeting the NBU requirements, that do not include some international standards.

The main source of information on the banks in Ukraine is the yearly statements, though the latter are incomparable with the similar documents of the banks in the developed countries as for the volume and completeness of information. In particular, only 8% of the banks under investigation provide the information on operations with related individuals, 30% – concerning the members of Supervisory Board, and 4% – on the principal borrowers [12; 50–52]. That state of affairs is hindering the objective assessment of financial statements of banks made by the interested persons, likewise it does not encourage attraction of extra resources to the banking system.

The analysis of the corporate governance in Ukrainian banking sector shows that at the moment the banks outrun the non-financial organizations in that respect. Alongside with that, the systems of the distribution of authorities between the bank managerial bodies has not yet been completely created, including the authorities respective corporate governing, the system of protection of shareholders' rights, specifically those of the petty shareholders, as well as the systems of making the information public. With the aim of further improvement of corporate governance practices, a variety of measures are needed to be taken.

As it was mentioned above, banks provide a specific kind of entrepreneurial activity, and general principles of corporate governance can not take into ac-

count the peculiarities of banking business. Therefore, the principles of corporate governance in banking organizations are required to be developed. The National Bank of Ukraine together with the Association of Ukrainian Banks should coordinate the development of that document.

The critical necessity in Ukraine is to create the unified reputable method for quality assessment of banking corporate governance. From the organization viewpoint, that assessment could be made by an independent institution.

It is feasible to introduce the mechanisms of risk rating, related to the shortcomings of corporate governance within the normative regulation of banking system, which would stimulate the banks to improve the internal procedures of corporate governance.

In the given context the banks should seclude a Committee out of the structure of the Supervisory Board, having the task to improve the corporate governance in certain companies, in particular, creation of information flows meeting the internal needs of the bank, and required level of bank transparency for external counter-agents.

We are facing a specific period finding ourselves at the beginning of restructuring of the banking system in our country. The compatibility of national banks in present and future will significantly depend upon the quality of corporate governance. In addition, the banks now should be concerned with the quality of corporate governance in the companies which are their clients, since the corporate governance is a critical factor in the system of banking risks management.

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