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Incentives, risk and governance

*Marko Kranjec**

The environment of incentive structures in the financial sector industry is today vastly different from that prevailing in the past. Not only managers of the "new" financial intermediaries, like investment funds, hedge funds or private equity firms, but also bank managers operate in an environment of intense competition for market shares and higher profits. This is not a bad thing in and of itself. It may, however, create perverse incentives for risk taking which is well beyond the prudent behaviour that is normally expected and mandated by prudential regulation. Incentive structures strongly influence the behaviour of financial intermediaries and may, through interconnectedness, endanger the stability of the financial system as a whole. The appropriate governance of financial intermediaries is therefore of primary importance.

The incentives to take risk are normally more pronounced in unregulated financial institutions which pursue high-return strategies in order to attract inflows and enhance compensation of their management. However, similar behaviour can also be detected in the banks, particularly in those with inefficient risk management practices or inappropriate internal supervision.

What can be done to improve corporate governance in financial intermediaries and align incentives to underlying risks? The financial crisis of the past three years has brought forward different proposals related to risk management practices and to the policy of compensations and bonuses. Most of these proposals are still at the working level.

Broadly speaking, two approaches could be considered. The first is to restructure the financial industry in such a way that the "utility" part of the industry is separated from the "casino" part. The "utility" part would provide deposit and payment facilities, and would invest strictly in non-risk assets. There would be full deposit protection and rather strict regulation of managers' pay. The "casino" part, on the other hand, would enjoy no public bail-outs and the monitoring of pay structures would be the duty of shareholders and depending on their perception of risk. In professional circles there is considerable scepticism regarding the feasibility and effectiveness of these proposals. Narrow banking or limited purpose banking, as these ideas are called, would most likely not prevent future financial crises and systemic instability. A variant of these proposals of a structural nature would be to convert financial institutions (corporations) into the legal form of full partnership, with unlimited liabilities of the owners, to raise their awareness of risks.

The second, more promising approach, proposes to deal with incentives. The basic idea behind these proposals rests on the premise that bank (or financial intermediaries more generally) employees, senior staff and management are responsible for the protection of the balance sheet as a whole. It is not sufficient to engage in highly profitable activities/products if this policy endangers the total balance sheet of the institution. Soundness of the institution depends on a broader set of considerations than short-term profitability and high bonuses. In ensuring such liability, sufficient time must be allowed to pass to form a judgment about the effects of the decisions on a long-term result and stability. Details of such proposals still have to be worked out, and should address such questions as: what is a personal liability of decision makers, how should this liability be assured, what portions of total remuneration should be allocated to contingent liabilities, would it be possible to insure against such liability, what would be the consequences of failure to future employment in the industry, etc.

There are many more ideas presently discussed in international fora of how to enhance financial stability through better regulation of incentives. In this context two ideas should be mentioned in particular: taxes on financial transactions to make speculation less profitable (Tobin tax), and levies on balance sheet liabilities to prevent excessive leverage. For these ideas to be introduced, a broad international consensus will be needed.

Contributions to this issue of Bančni Vestnik deal with many aspects of incentives and governance in financial intermediaries, and are a timely contribution to the international debate about the future of financial industry.

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Governance or management of nonfinancial business enterprises and banks

*Ivan Ribnikar**

GOVERNANCE OR MANAGEMENT OF NONFINANCIAL BUSINESS ENTERPRISES AND BANKS
Governance and management is not the same in English and therefore probably it cannot be the same in the Slovenian language either. At the beginning of the paper a few words about the mess involving management in our country that began already at the time of »workers' self management«. More important are, of course, various meaning of corporate governance or governance of business enterprises. This is the topic of the second part of the paper. At the end something about the peculiarities of banks, that determine who may be the bank owners and how their interests may be realised via bank management. Also in the case when the government is important bank owner.

JEL G21 G34 L2

In the first part of the paper we will say a few words about the semantic problems with corporate governance, when we have in mind the shortfalls of the Slovenian language. If official and scientific terminologies are taken literally, one may conclude that governance of an enterprise is the same as its management. Probably it should not be so. In the second part of the paper, various definitions of corporate governance are presented – besides Anglo-Saxon also usually neglected French. But even among Anglo-Saxon authors there are differences. In the third part of the paper, a few words will be said about corporate governance in banks in general and in banks where the government has as substantial stake.

* * *

We have entered, for known reasons, late into the world of corporations or companies, if the British term is used, and all the stuff and terms, connected with it. If we put aside the legal framework, there is a host of problems already with what is the meaning of various terms and how they should be translated in the Slovenian language. The problem we come across is already corporate governance itself.

Is it really the same as corporate management, as how it is translated in the Slovenain language? It seems that the use of the word »corporation« or, as adjective, »corporate«, instead of firm, business or business enterprise with the word »management« is already enough to express something quite different, and also new, modern, sophisticated, from the old and unsophisticated management of a firm.

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But the French do not use the word "corporation" at all. They talk namely simply about *le entreprise*. It seems that the adjective "corporate" is not essential. As is known the French have *gouvernement d'entreprise* (Plihon, 2001) or *gouvernance d'entreprise* (Peyrelevade, 2005; Batsch, 2002). Governance problems have also business enterprises that are not corporations or companies, for instance even if they are mutual.

So in Slovenia »corporate management« should be something different from the »management of a firm, corporation, and company or business enterprise«. Even schools, like the Faculty of Economics in Ljubljana, have corporate governance, corporate communications and the people, probably managers, responsible for it. It is probably the same "modern" approach to business that began already with the introduction of joint-stock companies twenty years ago. Once they were introduced one can hardly find the unfashionable and old words "firm", "business", "enterprise". Everything is "society", like French *société* it is our name for "company", and may mean any gathering of people - even if they gather in the pub for drink. That is not the case with "corporation" or "company".

There is one more detail. It looks namely that we have had problems with the term management for a long time. Probably not only with words, but we are talking about the words now. We had, for instance, workers' self management, although it was not management but control. Native English speakers were warned in several articles, that it was not workers' (self) management but control to dispel suspicion that our workers were special and can be managers. If we use the term that did not exist at that time, it was governance. It means workers' (self) control or workers' (self) governance.

It is not that much a semantic problem if English terms are translated in Slovene, one can get used to almost any term, but more the problem of understanding the meaning of terms, especially if the same terms are being used for different things. In such cases there is a great probability that the meaning of the terms is not known. But there will not be such problems in the text the follows. We will talk about corporate governance and not about management.

> *Corporate governance is relatively new term as well in English*

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Corporate governance is relatively new term as well in English. Not only the new term but the new way how business enterprises should be run. It appeared when so-called managerial capitalism, when managers were pretty autonomous in their business decisions, came to its end and was replaced by capitalism where shareholders or their interests became dominant or the only important - *capitalisme actionnarial* (Plihon, 2001). According to this new kind of capitalism, if we start with an extreme opinion, business enterprise is treated as assets or wealth whose market value, it is stock market value, should be maximised. All other is not important. It may look very strange, but it is maybe not quite so. Some important additional questions must be answered, whether this maximization should be in the short or long run and how much the market value of those assets should increase monthly, quarterly, annually, that we can say, that this maximisation is very strange or not.

Also if we talk about shareholding capitalism, corporate governance means generally more than that the only interest managers must pursue or take into account are the interests of shareholders - for instance always, it means also in the short run or in the very short run? But even if the interests of the owners are dominant, the managers cannot ignore those which are vital for their success, if they want the business enterprise to survive in the long run. In the case of banks they are for instance depositors, borrowers, and employees – but nevertheless at the end these are the interests of shareholders.

In the shareholding capitalism corporate governance is usually defined broader, but generally it relates only to the relations and problems within the company. So corporate governance subsumes (Greenbaum & Thakor, 1995), for instance, relationship between top executives and board of directors, in the case of American enterprises, relationship between the board and shareholders, incentive programs for employees, organizational design, leadership style, information sharing, and empowerment issues. There are narrow definitions, for instance that corporate governance deals simply with the ways in which suppliers of finance to firms assure themselves of getting a return on their investment (Schleifer & Vishny, 1997). It is a crucial question, because if it cannot be ensured there will be no inflow of funds into company and therefore no company. At the end or at the beginning it may be the substance of corporate governance or what business enterprises must ensure their lenders and owners. If we put aside lenders which get contractual returns on their loans, for the owners that have residual claim on the company is more important than for lenders that they trust business enterprises or their managers that there should be enough left for them. It cannot be otherwise, but the question is, how much is enough and, as has been said, does this evaluation take place often – for instance almost daily or not so often. Various pattern of corporate governance and/or the forms of capitalism differ in this respect.

Before we come to banks and corporate governance in banks, let us look at different patterns of governance (Walter & Smith, 2000) of business enterprises that one can find around the world. And these patterns differ also in what role in the control of business enterprises banks have. Walter and Smith talk about corporate governance, corporate control and corporate governance control, so we can talk either about control or governance – if we are not quite precise.
According to Walter and Smith there are four patterns of corporate control: the equity-market system, i. e. Anglo-American system, the bank-based system, i. e. German and French or, as Michel Albert (Albert, 1991) call it, *le modèle rhénan du capitalisme*, the 'bank-industrial crossholding system", it is Japanese system, and the state-centred system. It is obvious that there is in Slovenia a combination or mixture of bank-based and state-centred system.
For several reasons we, as all small transitional economies as well, will stay with bank-based system, and therefore it is important what kind of banks we have. The mixture with state-centered system will stay for some time and therefore it may happen again in the future that the Government may order banks, especially those that are partly in its ownership, to whom the bank loans should not be given or renewed – probably to the benefit of foreigners and certainly not to the benefit of business enterprises, to which the loans were not renewed, and to their business partners. Therefore, it is out of place to discuss fine details of governance or control, where lawyers are the most important discussants, if the behaviour of the Government and even private persons as owners is very strange. But only such unimportant details are being discussed so far. One can come to the conclusion

We can talk either about control or governance – if we are not quite precise.

the corporate governance is the domain of lawyers and that there is no substance but only formalities. There are other classifications of corporate governance and control (Aglietta, 2005). Michel Aglietta for instance also distinguishes four types of governance and control of business enterprises and accordingly four types of capitalism. There is "inside control + supervision by lenders" (*contrôle interne+supervision des créanciers*) in so called corporatist capitalism. When the business enterprise is controlled by the stock market (*contrôle par le marché boursier*) we talk about *capitalisme prédateur*. Then there is "control by block holders of shares" (*contrôle par les détenteurs de blocs d'actions*) in so-called *capitalisme d'élite financière*. The fourth type of control and governance is when business enterprises are controlled by institutional investors (*contrôle par les investisseurs institutionels*) and this type of capitalism is called capitalism of universal or general shareholder (*actionnaire universel*). These four types of control determine corporate governance: what are the goals of the firm, what is the structure of control and/or of supervisory and managing boards, what is the influence of financial environment. Others distinguish two forms of, for instance, antagonistic relations between the enterprise and the capital (Gréau, 2005) and critique of shareholding capitalism and shareholder value is often in France (Aglietta & Rebérioux, 2005).
Again in these four types of capitalism and corporate control the banks are important in corporatist capitalism or bank-based economies where business enterprises are supervised and/or controlled by banks – important suppliers of their funds. For our business enterprises bank loans are almost the only way how business enterprises are financed externally, and therefore banks must be important in governance and control of business enterprises. Therefore it must be important what banks we have, and how they are controlled and governed.

* * *

Banks are not only important but they are different businesses and, therefore, there must be differences when we come to their governance and/or control. The value of their assets is not determined on the market and they are not transparent. The true value of their assets may be hidden from outsiders for a long time. Besides their opaqueness, there is another difference. They are much more regulated and supervised by the authorities, like the central

bank, than other businesses. They can survive in the long run with very small equity capital, because they can diversify their portfolio and by spreading risk they can be a very highly-leveraged firm.
Although they are highly-leveraged firms, they nevertheless need equity. And when we come to equity, not all investors are suitable to be their shareholder. In some countries, like the USA, non-financial instituions are not allowed to be their shareholders. Because of a conflict of interest for non financial businesses they as bank borrowers cannot be bank shareholders was the explanation why. This explanation is not quite true any more. Big non financial businesses in the USA are namely financed almost exclusively directly on the financial market. But also in other countries, where there are not such prohibitions, normal or desired owners are financial institutions. Only they can namely guarantee stability in ownership and this stability is important for stability of management and also of the bank. Governance and control begins with owners and therefore a few words about it at the beginning.
As concerns bank owners or shareholders it is not only that non financial businesses are not good owners, because they will sooner or later sell their stake in the banks and invest proceeds in real assets that are specific for them. Besides, there are other investors that are not proper bank owners. Bank owners should not be investors who are inclined to go into great risks. They will namely choose or at least try to choose supervisory and management board with more or less the same inclination. It is at least partly prevented by approval that must be given by the central bank for investors with so-called qualified share in the equity. Another important requirement for investors to qualify for ownership in the bank is that they would be able to pay in additional capital if it becomes necessary. It is namely vital for a bank to have enough capital and it may happen that suddenly additional capital is required. So the number of suitable investors for bank ownership is further restricted.
That the banks are different, for instance from non-financial businesses, is somehow in a strange way confirmed by the system we had before. It may be worthwhile to make a short detour. The banks were not in social ownership like nonfinancial businesses but were owned by them. There was no workers' self management, i. e., as has been said, workers governance or control, in banks. All decisions were taken either by the representatives of owners, or founders as were called and management was in the hands of professionals – or at least they should have been professionals. The reason, why it was so, was that the banks were special but in a strange way. The work in banking was namely not treated as productive, it was said that it was in accordance with Marxian teaching, but the reason was probably something else. The banks were different from non financial businesses because they were doing their business predominantly on the basis of somebody else's money. And there could not be workers' control or governance, if there were among funds predominantly and permanently, and not only maybe for a short period of time, debts.

> *Shareholders may have more power in the two-tier system*

That the banks are different or special; it comes to the fore when we come to the question, who should be their owners or dominant owners, but when it comes to the system of management and control the same rules apply as for non financial businesses. There is the American or a single-tier board system with board of directors chaired by the chairperson, where are outside and inside directors with chief executive officer (CEO). Then there is the German two-tier board system with supervisory board (*Aufsichtsrat*) and management board (*Vorstandt*). The French have two types of boards of directors. Single-tier system is similar to the system in place in the USA but not identical. The board elects its chairperson, *président directeur-général* (PDG), who has more power than CEO. In a two-tier system, *conseil de surveillance* elects *directoire*. One of the members is *président de directoire* (Allen & Gale, 2004).
Both systems, or three systems if the French single-tier system is the third, may function well or bad, probably depending on who the shareholders are. Shareholders may have more power in the two-tier system (Allen & Gale, 2004) and costs of functioning various system may differ. But if there are problems with corporate governance, one should not try to find solution in changing a two-tier system into single-tier or vice versa. There are probably problems with owners, for instance the Government, whom they chose to represent them in the supervisory board and whom the supervisory board elected into managing board – if we stay with a two-tier system. Once elected, whether they are the right ones or not, in the supervisory board are they free-lance board members? They should be independent. It is a magic word for something to be good, independent also from those, who elected them?

This is especially true in cases when the government has stakes in banks. We cannot say that the state is not a proper bank shareholder because it is, for instance, a risk lover, which may be often the case with private investors. But the government may, for obvious reasons such as high positions in business enterprises are for instance rewards for some good work done or expected to be done in the future, for the political bigwigs, choose the wrong people to supervise and manage a bank. Therefore the proper governance of banks with substantial stake of the government in them may appear when this is not any more the case. Generally, this condition has not been met in transitional economies, and Slovenia is no exception.

Political parties with their bosses have very strongly articulated interests that are, according to them, not only different from but opposed to the interests of all other political parties although they are at the same time the interests of all people. It would be unusual that they would not try to exploit their national interests when there is the question of the governance of business enterprises, where the state is important shareholder. There is therefore hardly any place to articulate and bring into force national interests that are not particular.

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Is bank governance different?

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IS BANK GOVERNANCE DIFFERENT?
This paper discusses the importance of bank governance and how it differs from corporate governance of other companies. The paper continues with a discussion of recommendations for improved bank governance in the post-crisis world. Bank boards must become more responsible for risk management and must be aware that pleading ignorance about banking products or banking organizational structure is no longer acceptable. Three post-crisis global banking trends: expanded deposit insurance schemes, expanded regulation, and expanded government ownership of banks are discussed briefly.

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The purpose of this discussion paper is to provide an overview of corporate governance issues that are specific to banks. The first part of this paper will briefly introduce general corporate governance framework definitions, terminology, and open issues. The second part will explain why bank governance differs from corporate governance of others companies. The conclusion will examine bank governance through the last global financial crisis and discuss recommendations for improved bank governance mechanisms.

1. What is corporate governance?

At the core of corporate governance is the desire to minimise the principal agent problem, which occurs when the goals of the principal and agent conflict. It is difficult and expensive for the principal to verify that the agent has behaved inappropriately. To put it simply, a corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm.

We can track the origin of the modern corporate governance thinking to Adam Smith (1776), who defined in The Wealth of Nations the crucial question of corporate governance when he presented and explained the nature of the principal agent problem:

“The agents of a prince regard the wealth of their master as inexhaustible; are careless at what price they buy; are careless at what price they sell; are careless at what expense they transport his goods from one place to another...”

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The need for corporate governance mechanisms, therefore, stems from the need to monitor agents that are hired to manage companies on behalf of owners. This need always arises when ownership and managerial control of companies become separated. This separation forms the basis of the modern corporation where shareholders purchase stock and become residual claimants, and professional managers are contracted to provide strategy development and decision-making. The principal agent problem is the result of rational behaviour by managers that are rationally maximizing their own welfare within the framework of imperfect contracts they have with owners of the companies. The precise term "corporate governance" itself seems to have been used first by Richard Eells (1960) to denote "the structure and functioning of the corporate polity" (Becht et al. (2005)). Shleifer and Vishny (1997) defined corporate governance as dealing with "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."

a. Becht et al. (2005) provided a slightly broader definition of corporate governance. For them "corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders". Therefore, corporate governance is a set of processes by which investors attempt to minimise the transactions costs and agency costs associated with doing business within a firm. Corporate goals and mechanisms

It may be expressed that the goal of corporate governance is to fill in the 'gaps' in incomplete corporate contracts and control the managerial tendency to pursue interests and objectives that conflict with those of maximizing efficiency and value of companies and, thus, the wealth of owners.

Corporate governance mechanisms are internal and external. Internal corporate governance mechanisms are the activities of the board of directors appointed to hire and monitor managers. It is important that directors set appropriate compensation for managers (considered the second internal corporate governance mechanism) that aligns the interest of owners with the actions and interests of managers. Finally, ownership concentration is also an important corporate governance mechanism. The more concentrated the ownership of companies, the more likely managers will act in the interest of owners. Large block shareholders (often institutional owners) have a strong incentive to monitor management closely since they usually cannot exit the company without significant costs, so they tend to press for changes in companies and try to obtain board seats which enhance their abilities to monitor effectively. External corporate governance mechanisms are the pressures from participants in capital markets that observr managerial actions and express their views about those actions through the activities of buying and selling f shares in the companies managed by those managers. Falling share prices signal increased takeover threats that usually result in managerial turnover. Managers, fearing takeovers, therefore work harder to keep stock prices high and takeover chances lower and, as a consequence, the wealth of current owners is maximised. Market for corporate control is an important tool to discipline managers.

Banking activities are more opaque than activities in most other industries.

2. Importance of bank governance

Banks are essential to a well functioning market economy. When banks efficiently mobilise and allocate funds, the cost of capital to firms is lowered, capital formation is boosted, and productivity growth is stimulated. Thus, weak governance of banks reverberates throughout the economy with negative ramifications for economic development (Levine, 2004). During the last crisis, we painfully experienced this channel from banks to the rest of the economy. The crisis that began in the financial and banking sector quickly turned into a global economic meltdown.

a. Is governing banks different from governing other companies?

Banks are not "ordinary companies." Banking activities are more opaque than activities in most other industries. Banks are also subject to greater governmental regulation than most other companies. The existence of deposit insurance, high debt-to-equity ratios, and asset-liability issues, among other factors, may lead to greater conflicts of interest between various bank stakeholders. The complexity of the banking business increases the asymmetry of information and diminishes stakeholders' capacity to monitor the decisions of bank managers.

The number of parties with a stake in an institution's activity complicates the governance of financial institutions. In addition to investors, depositors and regulators have a direct interest in bank performance. Therefore, in order to evaluate reforms to the governance structures of banking firms, it is important to understand banking governance practices as well as how bank governance differs from other companies, especially less regulated firms.

On a more aggregate level, regulators are concerned with the effect governance has on the performance of financial institutions because the health of the overall economy depends on their performance. Moreover, the main aim of the regulator, which is to reduce systemic risk, might come into conflict with the main goal of shareholders, which is to increase share value. The conflicting goals introduce a new agency problem. Many view regulatory oversight of the industry as a substitute for corporate governance, or at least to view governance as less critical to the conduct and operation of banking firms. Others argue that effective supervision could lead to board oversight becoming a more critical element of banking firm governance—that is, these could be complementary forces. As regulatory reform has expanded the range of activities available to financial firms, it has become increasingly important for policymakers to understand the relationship between governance structure and the incentive for risk taking.

b. Inside governance is different in banks

Greater opaqueness of banks is the most important difference between bank governance and corporate governance. The greater informational asymmetries between insiders and outsiders in banking make it very difficult to disperse equity and for debt holders to monitor bank managers. Controlling owners have incentives to increase the bank's risk profile. While debt holders do not enjoy the upsides from risk taking, they also do not avoid the downsides if the bank cannot service its debts. The greater opacity of banks makes it more difficult for debt holders to control banks in this risk shifting. Opaqueness also makes it easier for insiders to exploit outside investors and the government. For example, La Porta et al. (2003) found high rates of connected lending in Mexico where almost one-fifth of total loans went to related parties. These loans benefited from interest rates that were significantly below those to unrelated parties.

c. Outside governance of banks is also different

The presence of regulation and the high leverage of banking firms may also affect the ability of external governance mechanisms to resolve the governance problems of these firms. For example, the absence of an active market for corporate control in the banking industry (hostile takeovers of banks are virtually impossible) prevents better performing firms from taking over the poorly performing ones and removing their boards. Blockholders are also more unlikely to gain seats through proxy fights and acquire additional information about a regulated firm.

In addition, outside blockholders behave differently too. Generally in an environment where regulators are active, blockholders are passive. In an unregulated environment, blockholders typically invest in the shares of undervalued companies. They then gain a seat on the board and exert pressure on management to restructure corporate assets and/or change corporate payout policy. A regulatory environment, on the other hand, may interfere with the information production and acquisition process, as disclosure of some information may be perceived by regulators as potentially causing bank runs.

3. Bank governance in the global crisis and policy response

Without analysing the details of the causes and roots of the last financial global crisis that spread to the real economy, it is safe to say that banks and the financial sector in general became the global public villain. So what actually happened? Were all banks equally affected by the crisis, or did some fare better than others? It may be too early to draw conclusions since the crisis, especially in Europe, is still unfolding. Researchers though are already drawing some conclusions, and it seems that better governed banks survived the crisis with fewer injuries.

Becht (2009) analysed bank governance during the current crisis. He observed that the last banking crisis has brought to light classic examples of board failure on strategy and oversight, misaligned or perverse incentives, empire building, conflicts of interest, weaknesses in internal controls, incompetence, and fraud. During the crisis, bank governance problems seemed similar to corporate governance problems in other unregulated industries. However, these bank governance failures have not followed a simple pattern. Becht saw problems at widely held banks, banks with a large shareholder, and banks controlled by the state. Equally there was no simple pattern across countries. Banks have collapsed in countries with weak shareholder rights and in countries with strong shareholder rights. Banks with weak governance have collapsed in one country, but banks with equally weak governance did not collapse in other countries. For him it is also unclear that blockholder controlled banks have been systematically more prudent and also that specialised activist funds are particularly well suited to act as "anchors of prudence" in banks. Becht's (2009) conclusion was that it is unclear as to who the culprit is and who the victim is, and it is likely that even with perfect governance at the level of individual institutions, systemic failure would have occurred.

Harald and Thum (2009) see the situation differently. They examined evidence for a systematic underperformance of Germany's state-owned banks in the current financial crisis to find out if bank losses can be traced to the quality of bank governance. They examined the biographical background of 593 supervisory board members in the 29 largest banks and found a pronounced difference in the finance and management experience of board representatives across private and state-owned banks. They constructed measures of "boardroom competence" and then related them directly to the magnitude of bank losses in the recent financial crisis. Harald and Thum's results show that the (in) competencies of supervisory boards in finance are related to losses in the financial crisis. Improved bank governance is therefore a suitable policy objective to reduce bank fragility. They found that the boards of private banks have on average higher levels of "boardroom competence" than boards of public banks, and that public banks booked higher losses than their private counterparts.

How did they measure "boardroom competence" as linked to bank performance during the last crisis? They analysed the educational background of board members. Desired characteristics were degrees in business or economics and, of course, the higher the completed educational level the better. They then looked for experience in the banking industry and financial markets. Interestingly they thought that it is also positive to have "U.S. Financial Market Experience" because managerial experience in overseas markets might provide the board member with access to better information and possibly better judgment on the institutional risks of the U.S. subprime market.

Gropp and Köhler (2010) added to the debate with their analysis of bank ownership concentration on bank behaviour during the crisis. They found that banks operating in countries with better shareholder rights and banks with a controlling shareholder recorded larger losses during the crisis than banks operating in countries with poor shareholder rights and banks without a controlling shareholder. In the period before the crisis, however, the owner controlled banks showed superior performance. These results imply that owner controlled banks incurred greater risks compared to manager controlled banks in the pre-crisis period. The profits of banks owned by a majority shareholder operating in a country with strong shareholder rights declined about five times as much during the recent crisis compared to widely held banks operating in countries with weak shareholder rights. Their results contradict the popular opinion that managers took advantage of insufficient control by shareholders to obtain compensation packages that disproportionately reward short-term risk taking. Results also do not support the idea that aligning the interests of management better with shareholders will reduce risk taking of banks, but instead suggest the opposite. Their findings are similar to those of Leaven and Levine (2009) who analysed 250 banks from 48 countries and determined that risk is generally higher in banks that have large owners with substantial cash-flow rights. Consistent with theory, greater cash-flow rights by a large owner are associated with more risk. Beltratti and Stulz (2009) further support the view that banks with boards having stronger links to large shareholders took higher risks before the crisis and were hit harder during the crisis. They examined 98 large, global banks and determined that banks with the highest returns in 2006 had the worst returns during the crisis. More specifically, the banks in the worst quartile of performance during the crisis had an average return of -87.44% during the crisis, but an average return of 33.07% in 2006. These banks were, on average, more likely also to have more shareholder friendly boards.

To cautiously summarise, it appears that the competence of bank boards is crucial to good corporate governance and that controlling shareholders, although considered beneficial for better corporate governance in most industries, may not be the most appropriate for banks. They tend to pressure bank managers to assume higher risks which results in higher profits in good times, but also higher losses during in bad times.

4. Recommendations for sound bank governance and observations of the post-crisis banking trends

The Bank of International Settlements published, in March of 2010, a set of principles for enhancing corporate governance. These principals emphasise the responsibility of bank boards for the overall risk strategy, including its risk tolerance, and risk management and internal control systems, including compliance policy. The principles also highlight the importance of political and personal independence of board members. The board should have a clear view of potential conflicts of interest, including those associated with controlling shareholders. The principles also state that "where there are controlling shareholders with power to appoint board members, the board should exercise corresponding caution." Bank boards must also be aware of their responsibility for adequate corporate governance across the group and not just the parent company. Bank board members and senior management should be aware of their duty to understand the bank's operational structure and the risks that it poses (i.e. "know-your-structure" principle), and also understand the purpose, structure, and unique risks of operations if the bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards. They should also seek to mitigate the risks identified (i.e. "understand-your-structure" principle). Further, boards should pay greater attention to compensation policies that should be aligned with prudent risk taking. The board should actively oversee the compensation system's design and operation, and monitor and review the compensation system to ensure that it operates as intended. Principle 11 states that "an employee's compensation should be effectively aligned with prudent risk taking; compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment. Large banks and internationally active banks and others depending on their risk profile and local governance requirements should have an independent senior executive. This executive is commonly referred to as the chief risk officer (CRO)."

It seems that the crux of these recommendations is that risk awareness in bank boards should be enhanced and that bank boards should be expected to have a "no excuse" attitude if something goes wrong. Bank boards are responsible, should be aware of that responsibility, and should act accordingly.

The global crisis impacted the banking systems across the world with three additional trends. First, deposit insurance schemes were expanded across the banking world. For example, EU directive 2009/14/EC amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay mandates that by 31 December 2010, the coverage level for the aggregate deposits of each depositor should be set at EUR 100,000. In many countries, including Slovenia, deposit insurance increased to cover larger, and, in some cases, even unlimited amounts. The intentions of the regulators, as I see them, were to avert the wide systematic bank panic. I believe, however, that deposit insurance should gradually be reduced to lower levels. Firstly, deposit insurance reduces the incentives of depositors to monitor banks, which directly hinders corporate governance, and secondly, deposit insurance induces banks to rely less on uninsured creditors with incentives to monitor and more on insured depositors with no incentives to exert corporate governance. Alternatively, if regulators want to keep deposit insurance schemes high in the long run, it may be a good idea that more dispersed bank ownership should be encouraged. Laeven and Levine (2009) show that deposit insurance is only associated with an increase in risk when the bank has a large equity holder with sufficient power to act on the additional risk taking incentives created by deposit insurance.

> *Controlling owners have incentives to increase the bank's risk profile.*

Secondly, the trend in global banking is increased regulation of banks (for example Basle III from September 2009 or the so called Dodd–Frank signed into law in the US in July 2010). Increased regulation is not necessarily bad, but we must, however, be aware of its perils. We must ensure that bank regulators remain completely independent of politicians and also banks. Beck, Demirguc-Kunt, and Levine (2003) have shown that powerful regulatory agencies tend to increase the likelihood that firms need corrupt ties with banks to obtain credit. They observed that if supervisors are independent from the government and have proper incentives, the likelihood that politicians will use the supervisory agency to induce banks to funnel credit to favoured friends is reduced. Similarly, if the supervisory agency is independent from banks and supervisors have proper incentives, then the probability that banks will "capture" supervisors is lowered.

New regulation across the world has also imposed general limits on the total remuneration of executives at institutions that have received capital injections or other financial help from the government. The measures are often justified by a moral hazard argument: bankers who were responsible for bringing about the current crisis should not be rewarded with taxpayer money after their institutions have failed. According to Becht (2009), this argument sounds attractive but comes with several problems. In terms of moral hazard, the remuneration restrictions tend to affect the wrong individuals and general remuneration restrictions across banks are likely to have perverse effects. New forms of remuneration will be invented that have the sole purpose of avoiding government regulation. Lastly, as was frequently pointed out in Germany, bank executives might be discouraged from applying for required capital injections because they do not want to become subjected to the associated constraints.

The most recent global change of the banking world is the reversed pattern in changes in bank state ownership. According to Demirguc-Kunt and Serven (2010), at the end of 2008, governments became the largest shareholders in most developed economies' financial industries, reversing a trend of state retreat over the last 20 years. Pre–crisis empirical research has for the most part shown that state ownership of banks is associated with less financial sector development, lower growth, and lower productivity, and that these negative effects are more pronounced at lower levels of income with less financial sector development and with weaker property rights protection (Barth, Caprio, and Levine 2001; La Porta, Lopez-de-Silanes, and Shleifer 2002). In addition, many papers provide evidence that state-owned banks tend to lend to cronies, especially around the time of elections, as vividly illustrated by the recent empirical studies of Cole (2008), Dinc (2005), and Khwaja and Mian (2005). Demirguc-Kunt and Serven (2010) explains the poor performance of bureaucrats as bankers with incentive problems are at the root of this issue since bureaucrats do not face incentives designed to reward efficient resource allocation. Government officials as bankers may also face conflicts of interest due to their desire to secure their political base and reward supporters, which often goes against efficient resource allocation.

That was the view before the crisis. Now, suddenly, government officials across the world are back in the banking saddle. While governments should be prepared to act in a systemic crisis, the approach and actions they take still need to be designed to reduce conditions for moral hazard and the likelihood of a subsequent crisis. This should be done by imposing real costs on all responsible parties and getting the resources back in productive use as soon as possible. In other words, if nationalization of banks was necessary to prevent the systemic risk, smart government should be aware of their limited skills and should try to re-privatise banks as soon as possible. Of course during this process the owners and managers that brought banks into the crisis should be "swept away".

Demirguc-Kunt and Serven (2010) conclude that if bureaucrats are not good bankers in good times, they are not likely to do better in bad times, given that the tendency for political forces to dominate economic judgments will be even stronger.

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Corporate governance in SKB Group and in Societe Generale Group

*Vojka Ravbar and André-Marc Prudent**

CORPORATE GOVERNANCE IN SKB GROUP AND IN SOCIETE GENERALE GROUP
SKB banka has been member of Société Générale Group since 2001. Due to the fact that SKB banka is majority owned by SG Group (99.7% owner) that already has one-tier governance system, SKB decided in June 2010 to follow suit and pass from a two-tier to one-tier governance system.
To have a known owner, being a big shareholder, also means that the ownership relations are clear, that all the strategic decisions made in agreement with the majority owner can be operationally carried out in practice in accordance with the national legislation. Namely, a responsible owner is aware of the fact that his principal capital consists of good performance of the company.
Société Générale Group and SKB pay strong attention to the professionalism, innovation and team work. These are the values that are implemented in practice in our daily work.

JEL G21 G34

SKB bank has been member of Société Générale Group since 2001. Société Générale Group (Société Générale S.A. Paris and Genefinance S.A. Paris) is the main shareholder of SKB banka with a 99.7% stake of SKB banka.

SKB banka is member of SKB Group which consists of SKB banka and SKB Leasing. SKB banka is a 100% owner of SKB Leasing.

SKB Group has been following the development of corporate governance of Société Générale (SG) Group for nearly ten years and trying to gradually introduce it in our SKB Group by taking into account our environment and Slovenian legal system.

SG and SKB Group are joint companies.

I.

By definition, corporate governance covers all the practical rules and organisation, management and control means of the Company aiming to guarantee secure and transparent business and balanced relationships between its management bodies, its control authorities and its shareholders.

According to the corporate governance rules established and implemented in SG Group it is important to stress that:

- The rules are quite comprehensive and regularly updated (approximately twice per year),

- All subsidiaries (SG group is present in 83 countries) are gradually introducing and following these rules taking into account the local regulation that may require some changes or adaptation,

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- Corporate governance covers all the practical rules and organisation, management and control means of the Company
- Corporate governance includes all the systems required to prevent and, where necessary, handle and correct all adverse events having a noticeable impact on its development, profitability and security,
- Corporate governance is managed by the company's managing bodies and other ad hock committees.

Each company has, depending on the environment, size, local legislation etc:

- General Meeting of Shareholders
- Governing bodies: Board of Directors or Supervisory Board, Management Board or General Management
- Committees reporting to the governing bodies to help them in their work on a certain number of specific topics
- Specialised internal committees supporting the managing team particularly in the management of risks and of internal control

Corporate governance rules are on one hand comprehensive and on the other hand quite detailed with:

- List of all different bodies or committees of the bank on different levels
- Standardised procedure to call the meeting, to prepare minutes, to inform competent people, to follow up the decisions etc.
- Who is, by position, expected to be a member of specific committee
- Expected frequency of the meetings
- Standard points that are supposed to be discussed in specific committees
- Minutes after each meeting
- .

SG Group is quite a big international financial group with headquarter in Paris and with subsidiaries all over the world in 83 countries, with 157,000 employees of 128 nationalities, with 32 million customers. In such a big system you need the rules and common practice if you want to develop business, to monitor the activities, to monitor the results, to be rational and efficient and at the same time to respect the national regulations, the national environment.

II.

As to the establishment of the body of a joint company two systems have been developed and consolidated in the comparative corporate legislation:

- Two-tier governance system
- One-tier governance system

SG Group already introduced one-tier governance system.

The governing and managing bodies in a two-tier system, which prevails in the Slovenian economic area, are the General Meeting of Shareholders, the Supervisory Board and the Management Board whereas a one-tier system knows only the General Meeting of Shareholders and the Board of Directors.

The significant difference between both systems is whether an intermediate body – Supervisory Board, assuming in a certain sense the function of the shareholders as owners – is set between the shareholders as owners and the Management Board or Executive Directors as management body.

SG Group already introduced one-tier governance system which has proved to be efficient in the practice. In Slovenia the possibility to introduce one-tier governance system in the legislation was rather late and in practice, in banking sector in particular, this system has not yet come to life.

We have to stress that in France the one-tier governance system is regulated in a different way than the one-tier governance system in Slovenia. According to the French acquis the President of the Board of Directors can be at the same time the Chief Executive Officer as well, whereas according to the Slovenian acquis this is not possible as these two functions are separated.

Compared to the two-tier governance system the one-tier governance system with the Board of Directors, joining the company governance function and at the same time supervises its implementation is more flexible and rational governance system, particularly for smaller joint companies and joint companies with a big ownership concentration and for the companies with a prevailing small number of bigger shareholders.

So, in one-tier governance system the functions that are divided in two-tier governance system between the Management Board and the Supervisory Board, are, as a rule, integrated in the hands of the Board of Directors that governs the company and supervises, at the same time, the realization of its operations.

The Board of Directors that represents the company is composed, as a rule, of the so called Executive and Non-executive Directors. In general, the Non-executive Directors are representatives of the company's capital owners. The Board of Directors can delegate the management of current operations to the Executive Directors. In general, the Board of Directors is much more acquainted with the company's operations than the Supervisory Board.

The purpose of one-tier governance system is to simplify the governing and supervisory functions of the company and to rationalize its operations. One-tier system allows much higher statutory autonomy than two-tier one, it enables a higher autonomy in the regulation of relations between the supervision and governance of the company as well as of the competences of each particular body. Both statutory provisions and Rules of Procedure for each particular body are important.

So, the Board of Directors manages the company and the Executive Directors manage the current operations. According to the Law, the Executive Directors, being at the same time also members of the Board of Directors, are representatives of the company as well.

Within the Board of Directors a closer tie can be established between the representatives of the capital and the Management acting as performer of their policies and on the other hand it is very important that there is a very clear distinction of competences between the Board of Directors and Executive Directors, i.e. between the supervisors and performers of operational tasks.

III.

Until June 2010, SKB banka had a two-tier governance system with the General Meeting of Shareholders, five-member Supervisory Board and two-member Management Board. The competences among all bodies were clearly distinguished and mutual informing was established. According to the Law the Audit Committee was appointed within the Supervisory Board and regularly reported to the latter. The Supervisory Board performed its function professionally and in a responsible way.

The cooperation of the Management Board with the Supervisory Board was on a high professional level as well and was always focused on a common objective – successful and secure operations of the bank despite the tense economic conditions. Due to the fact that SKB banka is majority-owned by SG Group (99.7% owner) that already has one-tier governance system, which proved in the practice to be efficient, in the spring 2010 SKB decided, in agreement with the majority owner, to pass from the two-tier to one-tier governance system as well.

One-tier system allows much higher statutory autonomy than two-tier one.

For this purpose the Management Board of SKB was enlarged in the first phase from the two-member to three-member Management Board. In line with the provisions laid down in the Slovenian legislation the Management of a bank must always have at least two persons duly authorised by the Bank of Slovenia (having the licence) for managing a bank.

At the same time the activities for amending-changing the bank's Statute and the Rules of Procedure for the General Meeting of Shareholders, preparation of the Rules of Procedure for the Board of Directors and the Rules of Procedure for Executive Directors were led as well.

In June 2010 the General Meeting of Shareholders of SKB banka unanimously :

- passed the new Statute of the bank which enabled the bank to pass from two-tier to one-tier governance system
- elected a nine-member Board of Directors of the bank (three members being employed in SG Group in Paris, three in SKB banka and three are independent) and
- passed new Rules of Procedure for the General Meeting of Shareholders

On the day following the session of the General Meeting of Shareholders of SKB the newly elected Board of Directors met at the session and passed the Rules of Procedure for the Board of Directors and appointed, among its members:

- the Chairman of the Board of Directors and her Deputy,
- the Executive Directors among the members of the Board of Directors – Chief Executive Officer and his Deputy and
- the members of three Committees :
  - Audit and Accounts Committee
  - Risks Committee
  - Compensation and Benefits Committee.

The whole process was well organized and managed with a support of major owner SG Group so that SKB bank was in no moment exposed to the risk of management. Since the President of the Management Board became Chairman of the Board of Directors (and can no longer be Executive) SKB banka has two previous members of the Management Board with licences of the Bank of Slovenia for managing the bank who were immediately appointed in General Management as Executive Officers - Chief Executive Officer and his Deputy .

IV.

In its Statute passed by the General Meeting of Shareholders of SKB banka, the bank also defined:

- scope of decision making by the General Meeting of Shareholders of the bank
- minimum number of the members of the Board of Directors and duration of their term of service
- competences of the Board of Directors
- Committees to be appointed by the Board of Directors as well as their competences
- tasks delegated by the Board of Directors to the Executive Directors
- tasks of the Executive Directors and their relation towards the Board of Directors
- etc.

In this way the competences and responsibilities of all participants in the bank's governing system and decision making are clearly distinguished already in the bank's basic document – the Statute.

Some of the key provisions of the Statute of SKB banka, referring above all to the role of the

- General Meeting of Shareholders of SKB banka and
- Board of Directors and its Committees are summarized hereinafter.

The General Meeting of Shareholders makes decision on the following issues:

- adoption of the Annual Report of the Bank,
- use of balance sheet profit,
- the appointment and dismissal of the members of the Board of Directors,
- granting discharge to the members of the Board of Directors,
- amendments to the Statute,
- measures to increase or reduce the share capital,
- the dissolution of the Bank and status-related changes,
- the appointment of an Auditor,
- the annual report of the Internal Audit Department,
- the adoption of rules governing its functioning,
- other matters determined by law.

The Board of Directors manages the bank and supervises the performance of its business operations.

Upon the proposal of Executive Directors the Board of Directors adopts:

- the business policy of the Bank ,
- the financial plan of the Bank (the budget),
- the organisation of the internal control system ,
- the rules regulating the functioning of internal audit,
- the annual framework program of the Internal Audit Department.

In line with the Statute Board of Directors

- examines the Annual report of the bank and proposes its approval to the General Meeting of Shareholders,
- examines the proposal for resolution on the use of balance sheet profit,
- supervises the adequacy of procedures and effectiveness of the Internal Audit Department performance,
- discusses the findings of the Bank of Slovenia, tax inspection Security agency (ATVP) and other supervisory bodies resulting from their supervision of the Bank,
- examines other financial reports and makes a written report to the General Meeting of Shareholders,
- explains to the General Meeting of Shareholders its opinions on the annual report of the Internal Audit Department and Annual Report,
- forms the Audit and Accounts Committee, Risks Committee, Compensation and Benefits Committee and other Committees, and
- performs other tasks in accordance with the law.

In line with the general definition of Corporate governance SKB pays serious attention to the work of the Committees of the Board of Directors, monitoring risks and audit statements in particular. The Committees are bound to report regularly to the Board of Directors, so that the members of the Board of Directors receive comprehensive information on the bank's performance.

According to the experience of SG and Slovenian legislation SKB defines :

- responsibilities of the Audit and Accounts Committee, in particular:
  - monitoring the financial reporting process;
  - monitoring the internal controls system, internal audit and the risk management systems in the bank;
  - monitoring the obligatory audit of annual and consolidated financial statements;
  - reviewing and monitoring the auditor independence for the purpose of annual report of the bank, particularly with regard to the provision of additional non-audit services;
  - proposing to the Board of Directors the appointment of the candidate for the auditor of the annual report of the bank;
  - supervising the integrity of financial information issued by the bank;
  - assessing the composition of the annual report including formation of the proposal for the Board of Directors
  - cooperation in determining the important segments to be audited
  - cooperation in preparing the agreement between the auditor and the bank;
  - other tasks defined by Statute or a decision adopted by the Board of Directors
  - cooperation with the auditor in auditing the bank's annual report particularly by mutual information on major issues concerning the audit.
  - ensuring that all works monitored by the Audit and Accounts Committee is up to date with changes in the legal and regulatory environment.

- responsibilities of the Risks Committee, in particular:
  - analyses, on a periodical basis, of the organization and functioning of the bank's risk management departments ,
  - review of the portfolio of credit and market risks to which the bank is exposed,
  - as regards counterparty risks, the Risk Committee reviews the following points:
    - the content of and changes to the portfolio by the type of facility and debtor,
    - the regulatory ratios and key indicators (consumption of own funds by major risks, risk worsening ratios, concentration risk per sector, cost of the risk, etc,),
    - changes to the quality of commitments
    - compliance with the authorizations
    - adequacy of the level of provision for the risks incurred,
  - efficiency of debt collection.

All the details are further specified in the Rules of Procedure of the Board of Directors and Rules of Procedure regulating the work of the Executive Directors as in other internal documents of the bank.
In order to govern and supervise the bank as efficiently as possible, the General Management of the bank, operationally managing and representing the bank, has established several working bodies – decision making or advisory – with the defined composition of members, sessions frequency and scope of operations (current monitoring of business results, monitoring of assumed risks, monitoring and managing of the bank's liquidity, decision making on bank's projects and their implementation, security, human resources policy, marketing and communications etc.). Adequate attention is also paid to informing the employees. All the above is a part of the corporate governance of the bank.
When establishing and defining the processes in the bank it is important for the process of operations with individual clients to clearly separate the process of commercial treatment of the clients and the process of risk assessment of exposure towards this client. By doing so it is eliminated the possibility of the client's personal impact on the establishment of the client's risk assessment level. It is the Commercial Division that meets and discusses with the client and propose the facility and the exposure towards this client which is validated by Risk Division.

SKB implemented the Code of Ethics already several years ago.

Société Générale Group and SKB pay strong attention to the professionalism, innovation and team work. These are the values that are implemented in practice in our daily work. In this perspective all our members of the Board of Directors have corresponding educational level, experience in financial and banking operations, they perform their work conscientiously and professionally. The members of the Board of Directors have the possibility of access to the books and documentation of the bank, to demand various reports on operations for each particular field, clients, they meet internal auditors and at least once per year external auditors as well, etc.
The remuneration method for the members of the Board of Directors and the members of the Committees for their work is defined by SKB at the General Meeting of Shareholders. SKB does not remunerate the members of the Board of Directors either with options or other similar financial instruments, neither are they entitled to special awards with regard to the results achieved by the bank. They have therefore no interest for hiding any fact or to unsuitably adjust the results of operations since better results of the bank do not mean any additional income for their work.
Our employees are an important part of professionalism, innovation and team work in the bank and it is in this perspective that they are given regular trainings.

V.

SKB banka as well as the SKB Group builds its corporate governance system in accordance with the development of the corporate governance in SG Group to which it belongs as well as in accordance with the possibilities provided by the Slovene legal system.
SKB's advantage is to be a part of a big international financial group which operates in a strategic and transparent way and transfers its own experience to all the parts of the system that, on one hand, tries to standardize things as much as possible but is, on the other hand, willing to listen to the constructive proposals of the banks in the Group and to take into consideration the specificities of national legislations. It is our advantage to have our headquarter in the country being a part of the European Union like the headquarter of our parent company SG Group – we are therefore all bound to respect the EU rules, both at the parent bank and our bank. This also gives us the possibility to compare the implementing regulations in order to try to find

synergies and to ensure the transfer of know-how and experience. This often enables us to rationalise the operations, to use common tools for operations, to rationalize our purchases and to use certain technological assistance, equipment etc.
Considering the tough worldwide economic situation it is an advantage for smaller banks to be a part of a bigger reputable financial group that learns on the basis of its long-year experience and transfers this know-how by implementing certain orientations for the work within the Société Générale Group as a whole. The advantage of being a part of such a financially strong group also enables us to tap into funds for sound project relatively quickly and it consequently enables us to be more competitive in the market and to develop more rapidly. In such circumstances SKB banka is able to assist its clients in various markets and in various operations as we can easily establish a connection with sister-banks in other countries in which our clients find interest for cooperation. This is also one of the principles of our corporate governance and corporate culture.
To have a known owner, being a big shareholder (99.7% in case of SKB), also means that the ownership relations are clear, that all the strategic decisions made in agreement with the majority owner can be operationally carried out in practice in accordance with the national legislation. In such cases the bank does not spare much time in convincing the majority owner and the majority of minor owners of its problems or proposals – in fact it is the owners who try to listen and to follow, with all the due responsibility of the owner, the good proposal made by the bank. Namely, a responsible owner is aware of the fact that his principal capital consists of good performance of the company and that if in case of problems the corresponding and timely measures are not taken he might lose a part of or even the entire property, that his reputation might be affected and that the failure might be followed by not only material but also carious legal consequences....
Corporate governance also imposes the respect of certain rules of conduct within the company, within the Group as well as outwards. Therefore SKB implemented the Code of Ethics already several years ago which has to be respected by all our employees and is a part of our culture of conduct. In SKB as well as in Société Générale Group as a whole a special attention is paid to maintenance and growth of the bank's reputation. We are aware that with a long-term perspective a company can be successful only when it is well integrated in the social and economic environment in which it operates, by co-creating the image of its environment in a permanent, active and responsible way. This is also the reason for SKB Group's decision to express its support in a form of various financial contributions in various domains – culture, education, sport, health care or in a form of assistance to socially handicapped individuals or groups. All this, as well as numerous other activities led in SKB, are a part of our corporate culture and corporate governance.

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Corporate governance in Slovenia: determinant analysis

*Franjo Štiblar and Meta Ahtik**

CORPORATE GOVERNANCE IN SLOVENIA: DETERMINANT ANALYSIS
The article analyzes the impact of the structure of ownership (concentration of ownership, provenience of owners) as key determinant of corporate governance on bank performance. Slovenian banking sector in years 2000 and 2008 is subject of empirical analysis. The major findings are that in the process of second consolidation of banking sector concentration of bank ownership (the share of largest owner) and the share of foreign owners and funds as owners increased between 2000 and 2008. At the same time, banking sector performance did not experience radical improvement. While expansion of banking was strong in this eight-year period, especially credit growth, cost efficiency improved, but income efficiency and solvency of banks declined on average. Such development was in fact an interlude into global financial crisis which has its negative impact in the Slovene banking sector too.

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Corporate governance includes several aspects in managing of the company. Soft elements are usually unobservable. Among observables, available for quantitative empirical analysis, the important factor is ownership of the company,[1] which is subject of this paper. Concentration of owners and their provenience are used in partial cross section analysis as determinants of performance of banks in Slovenia. Calculations are made for two years, for 2000, after first phase in consolidation of banking sector was completed, and for 2008, after second step in consolidation was completed with Slovenia's membership in the EU and euro area. Results for both years are relevant on their own and in addition they are compared, where it needs to be taken into account that due to the emerging global financial crisis in 2008 the usual ceteris paribus assumption required for such inter-temporal comparison does not fully apply.

1. Introduction

The structure of paper is as follows: introduction is followed by theoretical part, which presents definition of corporate governance, its specific role in banks and the impact of ownership concentration and provenience of owners on corporate governance.

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[1] Other determinants of corporate governance of company (bank) include also the interests of all other stakeholders. In banks, there are borrowers, depositors, employees, supervisors, regulators and others, but they are not subject of this study.

In empirical part, firstly, basic statistics are given for the Slovenian banking sector for 2000 and 2008 regarding concentration of ownership, provenience of owners and overall performance of banking sector in both years. Second, partial regression analysis is applied to estimate the impact of ownership structure on banking performance in Slovenia. The paper concludes with generalization of the results obtained.

2. Theory of corporate governance (with emphasis on ownership)

2.1 Definition

Corporate governance is usually represented through so called contractual theory of the firm with agency problem as an essential element. Agency problem arises when the welfare of one party ("principal") depends upon actions taken by another party ("agent"). The problem lies in motivating the agent to act in the principal's interest rather than simply in his own interest. Since contracts are incomplete and managers possess more expertise than shareholders, managers typically end up with the residual rights of control, which gives them great possibilities for self-interested behaviour. This might result in managers taking highly inefficient actions, which cost investors far more than the personal benefits managers receive (Shleifer & Vishny, 1997). In a corporate structure principals are usually stockholders, while agents are those included in the board of directors or management board. Different institutions and authors define corporate governance differently.

To start with the key institution, general principles of corporate governance introduced by the OECD in 1998, and recently renewed, include:

- protection of shareholders' rights,
- impartial treatment of shareholders,
- active participation of shareholders in realization of common goals of company,
- necessary transparency of information for company,
- responsibility of supervisory board to provide strategic leadership of company and efficient supervision of the board.

Cadbury Committee (1992) defined corporate governance as a "system by which companies are directed and controlled." It is possible to notice that corporate governance is defined as a set of mechanisms through which firms operate when ownership is separated from management.

Banks are generally more opaque than nonfinancial firms.

In the so called narrow or "monitoring model" central function of the board is to safeguard the interests of the shareholders. However, Andrews (1982) characterises the monitoring model as simplistic, overformal and self-defeating and sees so called "participative board" with outside board members invited to join with the management to enhance the quality of strategic decisions as an ideal. Williamson (1985) agrees to some extent and allows for other stakeholders such as workers (highly specialised work that required specific investment to be educated in order to benefit to the firm), lenders (in case of very high leverage) or even customers to be represented in the board. Especially the issue of high debt-to-equity ratio should be of great importance for board composition and corporate governance of banks. American model of corporate governance with "increasing shareholder value" maxima has been widely promoted (La Porta et al., 1998), although it is possible to claim that recent financial crisis represents its demise. Major deficiency of this system, promotion of short-term goals at the expense of long-term success, triggered present financial crisis. Improper system of remuneration of managers led to reckless and excessive risk-taking. Many non-executive directors (as well as supervisory board members) failed to act as an effective monitor and challenge to executive managers. Non-executive directors in the banking sector kept operating as members of a "cosy club" rather than providing effective control of executive members of boards. Institutional investors, so much promoted as responsible owners, have failed in scrutinising and monitoring the decisions of boards and executive management in the banking sector (OECD, 2010; House of Commons Treasury Committee, 2009). Taking into account broader corporate governance definition developed by Williamson (1985) and to some extent already present in continental legal environment (although rebuffed by promoters of Anglo-Saxon model) might be the answer to the question about future of corporate governance culture.

2.2 Corporate governance of banks

besides general corporate governance principles described above there are some peculiarities developed for corporate governance of banks. They have two characteristics that require separate analysis (Levine, 2004).

First, banks are generally more opaque than nonfinancial firms. Informational asymmetries in banking business are much larger than with other corporations. For example, loan quality is not readily observable and can be hidden for long periods. Banks can alter the risk composition of their assets more quickly than most non-financial industries and hide problems by extending loans to clients that cannot service previous debt obligations.
Second, banks are normally very heavily regulated due to their importance in the economy and due to opacity of bank assets and activities.2 Situation is even emphasised with explosion of international standards (BIS, etc.) and EU level regulation. Government regulation affects the behaviour of banks as well as corporate governance processes.

2.3 The role of ownership structure

information asymmetries connected with banking industry complicate preparation of contracts that align managers' interests with bank equity holders' interests. When outcomes are difficult to measure and easy to influence in the short-run, managers will find it easy to manipulate their pay-offs contracts. By controlling significant pools of resources, bankers can move asset prices that trigger payments to themselves under incentive contracts. Furthermore, since managers frequently control the boards of directors that write the incentive contracts, managers of opaque banks can often design compensation packages that allow managers to benefit at the expense of the long-run health of the bank (Levine, 2004).

2.3.1 Concentration

Diffuse shareholders exert corporate governance by directly voting on crucial issues, such as mergers, liquidation, and fundamental changes in business strategy, and indirectly by electing the boards of directors to represent the interests of the owners and oversee managerial decisions. Incentive contracts are a common mechanism for aligning the interests of managers with those of shareholders.
A variety of factors prevents diffuse shareholders from effectively exerting corporate control. There are large informational asymmetries between managers and small shareholders and managers have enormous discretion over the flow of information. Small shareholders frequently lack the expertise to monitor managers. Besides that prohibitively large costs (in comparison with investor's small stake) associated with monitoring may cause a "free-rider" problem: each investor relies that others are monitoring managers, so there is not enough monitoring.

Banks are normally very heavily regulated due to their importance in the economy.

The supervisory board or board of directors will often not represent the interests of the minority shareholders. Minority shareholders' rights are often not protected properly and/or enforcement of the existing rights is not adequate. This gives managers a significant discretion over the control of corporate assets.
Concentrated ownership represents a mechanism used for preventing managers from deviating too far from the interests of owners. Large investors have the incentives and means to acquire information and monitor managers. They can elect their representatives to the board of directors and influence the board more thoroughly. Large shareholders will also be more effective at exercising their voting rights than an ownership structure dominated by small, comparatively uninformed investors. Finally, they can more effectively negotiate managerial incentive contracts that align owner and manager interests than small shareholders whose representatives (supervisory board or the board of directors) can be manipulated by management.
Concentrated ownership raises some corporate governance problems. Large investors may pay themselves special dividends and exploit business relationships with other firms they own that profit themselves at the expense of the bank. Large shareholders maximise the private benefits of control at the expense of small investors.
Most regulations restrict the concentration of bank ownership and the ability of outsiders to purchase a substantial percentage of bank stock without regulatory approval. These restrictions may arise due to concerns about concentrations of power in the economy or about the type of people who control a bank. Usually purchasers of bank stock have to alert government officials as their holdings increase above a certain level, and may need regulatory approval above some proportion.[3] Additionally, there may be constraints on the type of bank ownership, such as prohibition of ownership by nonbank firms, securities firms or insurance companies. However,

[2] An extreme situation is state ownership of banks.
[3] For example Articles 45 - 59 of the Slovenian Banking Act (Official Gazette of RS Nos.131/06, 1/08, 109/08, 19/09, 98/09)

government regulatory restrictions are often ineffective, since it is possible to build an influence (ownership control) in the bank through different hidden channels, which of course depend on (insufficiency of) legislation (Levine, 2004). Besides that, as shown by Caprio, Laeven, and Levine (2007) in average around the world 75 percent of banks have a controlling single owner. Of these controlling owners, more than half are families. This means that regulatory restrictions on share purchases defend the existing owners from competition for control.

2.3.2 Provenience of shareholders State vs. Private ownership

according to social view, state ownership is beneficial, since public banks follow social objectives. They may finance projects that generate positive externalities and that would not be financed privately, such as infrastructure projects or higher education (Hainz & Hakenes, 2007). They provide financial services and funds to people and regions that are not served by private banks. Similarly, according to the development view state-owned banks may foster economic development by substituting for private financing in an environment with weak economic and financial institutions (Körner & Schnabel, 2010).
On the other hand agency view and political view list several deficiencies of State ownership. State owned firms are controlled by the public, while the de facto control rights belong to the bureaucrats that have extremely concentrated control rights, but no significant cash flow rights. They may have goals that differ from social welfare, and are dictated by political interests (assisting special interest groups that help them win elections) (Shleifer & Vishny, 1997). Board members of state owned banks are often chosen in opposite with first of the Sound corporate governance principles developed by BIS (2006). Product and business development decisions will favour whatever is to the government's short-term advantage, which may not be in the best interest of the bank and other stakeholders, such as creditors (Gandy, Shaw, Tebbutt & Young, 2007). Conflict of interests appears because of co-existence of two functions: ownership and regulation (Levine, 2004). The differences between public and private banks should be less pronounced in well-developed financial systems with adequate level of institutions and rule of law.

Minority shareholders' rights are often not protected properly.

However, recent macro level empirical analyses of efficiency of State ownership do not confirm those theories. Analyses of Micco, Panizza and Yanez (2007), Körner and Schnabel (2009) and Körner and Schnabel (2010) show that public ownership of banks is harmful only when financial development and the quality of political institutions are low. Unlike La Porta et al. (2002) they find that negative effect of public ownership disappears when country reaches certain (relatively low) level of financial development and institutions quality.

Foreign vs. Domestic ownership

banks that are subsidiaries or branches of foreign institutions are able to acquire cheaper means within the banking group due to lowered information asymmetry in relationship bank mother – subsidiary/ branch or in financial markets due to connections with larger, more known financial institution (Ahtik, 2010). However, foreign owned banks often boost economic cycles in a certain economy, since they are able to acquire cheaper means of financing

Table 1: Frequential distribution of banks in Slovenia by share of the largest owner, 2000 and 2008.

YEAR	2000	2008			
PERCENTAGE		**All**	**State**	**Private**	**Foreign**
0 – 10	1	0	0	0	0
Above 10 - 20	5	1	0	1	0
Above 20 - 30	3	1	0	1	0
Above 30 - 40	5	1	0	1	0
Above 40 - 50	2	5	1	4	0
Above 50 - 60	0	1	1	0	0
Above 60 - 70	1	0	0	0	0
Above 70 - 80	2	1	0	0	1
Above 80 - 90	2	1	0	0	1
Above 90 - 100	3	10	1	1	8
Number of banks	24	21	3	8	10
Average	46	70			
Modified HHI	0.385	0.661			

Source: Financial Statements of Banks in 2000 and 2008; Ljubljana: ZBS, 2001, 2009; own calculations.

Table 2: Provenience of the largest shareholder.

PROVENIENCE	2000		2008	
	N	%	N	%
Foreign	5	21	10	48
Bank – domestic	7	29	2	9
Fund	0	0	4	19
Non-financial corporation	6	25	1	5
State	4	17	3	14
Insurance company, other	2	8	1	5
ALL	**24**	**100**	**21**	**100**

Source: Financial Statements of Banks in 2000 and 2008; Ljubljana: ZBS, 2001, 2009; own calculations.

Table 3: Performance of banking sector in Slovenia in 2000 and 2008.

	2000	2008
SIZE		
TOTAL ASSETS OF BANKS (mn EUR)	13683	47628
CAPITAL (mn EUR)	1193	4001
A/GDP	78.9%	128.3%
EFFICIENCY		
PRODUCTIVITY (ASSETS/EMPLOYEE)	1.3	3.9
PROFITABILITY		
ROA	1.10%	0.68%
ROE	11.30%	8.14%
COST EFFICIENCY		
COSTS/ASSETS	2.9%	1.5%
COSTS/EMPLOYEE IN '000 EUR	32.5	58.4
SOLVENCY (CAR)	13.5%	11.6%
CREDIT/DEPOSIT	0.87	1.62
MARKET CONCENTRATION		
K5	62.8	58.9
HHI	1376	1278
INTEREST MARGIN ON TOTAL ASSETS	4.5%	2.1%
CAPITAL/EMPLOYEE ('000 EUR)	109	327
PROVISIONS/LOANS	4%	4%
OPERATING COSTS (mn EUR)	294	776
NUMBER OF EMPLOYEES	10929	12233
EMPLOYEES/BANK	437	471
NUMBER OF BANKS (CREDIT INSTITUTIONS)	25	26
ASSETS/BANK (mn EUR)	547	1832
CAPITAL/BANK (mn EUR)	48	154
LOANS	7493	28426
DEPOSIT	8593	17537

Sources: BoS, ZBS.

and place them where they expect highest revenues. When they face lack of means in their home countries, they can withdraw those means as well (Micco & Panizza, 2004). This redistribution of resources might on one hand increase bank's profitability, but might, on the other hand, increase its variability and instability of the banking environment.

3. Empirical analysis

3.1 Basic statistics

3.1.1 Concentration of bank ownership in slovenia

Data in Table 1 show that ownership (measured by share of the biggest owner) was rather dispersed in 2000, while concentration of ownership took place in the following eight years. In 2000, the largest shareholder possessed less than 25% of bank shares in a third of banks, while in more than one half of banks the largest shareholder possessed less than a third of capital (Štiblar, 2001). Over the years, ownership cumulated around two frequency peaks – first, around 30 - 40% represents opportunity of a passive control that gives possibility to block certain decisions, while the other one, above 75% represents the possibility of total control of the bank. Average share of largest owner increased from 46% in 2000 to 70% in 2008. In most cases biggest owner had either a 40-50% share (above control, but just below majority share (50%)) or more than 90%, which represents total control for the first owner. Private domestic ownership was most concentrated, while foreign owners typically possessed controlling share – above 75% (only one bank being an exception). Concentration of ownership in period 2000-2008 was especially strong in the subgroup of banks with foreign owners (last column in Table 1) which can be explained by the fact that those banks are mostly smaller (they were mostly founded as green field investments before 2004, when forming of branches had not been eased with EU legislation yet). Additionally minority owners might have been experiencing some doubts about the rule of law in Slovenia. Modified HH Index, calculated as weighted sum of percentages of ownership by largest owners, increased from 0.385 to 0.661 (by 72%).
The average share of largest owner increased between 2000 and 2008 by 50% to 70%.

3.1.2 Provenience of bank owners in slovenia

Largest owner of banks in 2000 were: in most cases other domestic

Figure 1: Determinants of bank performance.

Source: own.

Table 4: List of variables.

VARIABLES	
SYMBOL	DESCRIPTION
A	total assets, million tolars (2000) or thousand EUR (2008)
A/Z	total assets per employee
CAR	capital adequacy ratio, %
DBN	realised interest rate for deposits of banks and non-banks, %
DELTRGA	market share, %
DNEB	non-bank deposits,%,
IN	net interest income, million tolars
INLNEB	net interest rate for loans to non-banks,%
K	total capital, thousand EUR
KBN	realised interest rate for loans to banks and non-banks,%
KC	total capital, million tolars,
KCZ	total capital per employee, 100 million tolars
KR	regulatory capital, million tolars
KRZ	regulatory capital per employee, 100 million tolars
KZ	total capital per employee, thousand EUR
LAST1O	largest shareholder' share; concentration of ownership,%
LAST5O	five largest shareholder' share; concentration of ownership,%
LASTD	majority ownership: State=1, otherwise=0
LASTP	majority ownership: private, domestic=1, otherwise=0
LASTT	majority ownership: foreign=1, otherwise=0
LASTTO	share of foreign ownership,%
LNEB	credit to non-banking sector, million tolars
LNEB/DNEB	loan-to-deposit ratio of non-banks (secondary emission),%
OM	interest rate margin as difference between active and passive interest rate,%
PROFNO	net profit-to-gross profit (indication of tax burden),%
PROFZ	profit per employee, million tolars, thousand EUR
REZ/LNEB	provisions-to-loans to non-banks,%
ROA	return on assets,%
ROAB	gross profit per assets (profitability of business),%
ROE	return on equity,%
ROEB	- return on equity before tax, v %
ROEN	- net return on equity, v %
ROET	return on equity after tax, %
RL	provisions-to-loans/total loans, %
S	operational costs, million tolars
S/A	operational costs per average total assets, %
S/Z	operational costs per employee, EUR (2008)
Z	number of employees

banks (7), non-financial corporations (6), foreigners (5), state (4), insurance company (1) and other (1). The owner (except in case of non-financial corporations and association) possesses at least 25% of shares. Bank as largest shareholder has in average larger share than a non-bank owner (Štiblar, 2001). Share of foreign ownership started increasing in the late 1990s (Štiblar, 2004) causing most frequent owners in 2008 to be foreigners, especially parent credit institutions that established subsidiaries or branches in Slovenia.

Between 2000 and 2008 the share of foreigners as the majority owners more than doubled (from 21% to 48%). The share of funds as the first owners increased as well (from 0% to 19%). For that reason the share of other largest owners declined: domestic banks from 29% to 9.5%, nonfinancial corporations from 25% to 5%, the state from 17% to 14% and insurance companies from 8% to 5% (Table 2).

3.1.3 Performance of banking sector

Comparison of both years indicates a strong expansion of banking in Slovenia between 2000 and 2008. Total assets and capital as well as their shares in GDP increased by more than threefold, and the share of banking assets in GDP increased from 78.9% to 128.3%. At the same time, while productivity and cost efficiency improved, profit efficiency declined substantially (2008 is a year of starting global crisis). In addition solvency ratio declined, interest margins were much smaller, provisions for loans retain the same share in total loans, number of employees increased by 12% only. While loans expanded by 3.8-times, deposits increased twofold only thus leading to enormous increase in loan/deposit ratio from 0.87 to 1.62. This is indication of escalation of external financing which became one of the main factors of financial crisis, when international financial flows collapsed and deleveraging took place as credibility vanished.

Basic conclusion is that increased concentration in the banking market and increased presence of foreigners and funds as largest owners is correlated with increase of banking sector activity in GDP and productivity and credit expansion, improved cost efficiency, but decreased profit efficiency and solvency.

Table 5: Influence of corporate governance on performance of banks, Slovenia, 2000.

Eq.	Y		C	X_1	X_2	X_3	X_4	R^2	F
1-2000	ROEB		8.542 (6.68)	0.264*DELTRGA (1.65)	-0.0698*LASTTO (-2.97)			0.379	6.42
2-2000	S/Z		464.84 (3.71)	464.84*LASTTO (1.64)	1.792*Kr/Z (1.79)	42.45*OM (2.31)		0.474	6.00
3-2000	S/Z		616.1 (4.56)	2.654*LAST50 (1.32)	1.934*LASTTO (1.923)			0.335	5.30
4-2000	S/A		2.74 (6.25)	-0.000185*Kc/Z (-2.32)	0.0111*LAST50 (2.13)			0.290	4.29
5-2000	ROAB		0.776 (2.57)	0.442*LASTP (1.90)	-0.00014*Kr/Z (-2.38)	0.839*RL (1.48)		0.440	5.25
6-2000	ROAB		0.918 (3.12)	-0.0901*LASTTO (-2.44)				0.35	11.86
7-2000	PROF/Z		332.484 (2.66)	179.2*LASTP (2.22)	-11.96*CAR (-1.85)			0.275	4.00
8-2000	LNEB/DNEB		96.754 (12.3)	0.414*LASTTO (4.99)	-4.5*INLNEB (-3.34)			0.63	17.9
9-2000	LAST10		14.00 (1.06)	36.63*LASTT (2.82)	5.378*OM (2.06)			0.374	6.29
10-2000	LAST10		81.43 (12.6)	-52.95 LASTP (-6.69)				0.671	44.87
11-2000	DELTRGA		0.884 (0.513)	10.47*LASTD (3.55)	0.239*ROEB (1.34)			0.449	8.55
12-2000	DELTRGA		9.0 (2.44)	-6.8*LASTP (-3.80)	-0.0011*Kr/Z (-1.63)	0.3982*ROEB (1.79)		0.446	5.38
13-2000	CAR		14.9 (5.97)	-7.4*LASTD (-2.42)	1.07*INL (2.58)	-0.011*PROF/Z (-2.24)		0.416	4.74
14-2000	A/Z		27382 (8.14)	-42.9*LASTTO (-2.5)	0.9*Kr/Z (2.11)	-10980*S/A (-12.0)	39*S/Z (13.28)	0.95	107

Source: Financial Statements of Banks in 2000 and 2008; Ljubljana: ZBS, 2001, 2009; own calculations.

3.2 Regression analysis

3.2.1 The model

the aim of the analysis is to quantify the influence of corporate governance of banks on performance of banks. It is possible to create a causal chain that links the ownership structure, corporate governance and bank performance (Figure 1). The ownership structure (concentration and provenience of ownership) shapes corporate governance culture of the bank. The type of corporate governance finally determines the bank performance indicators (productivity, profitability, cost efficiency, solvency and interest rate margin).

3.2.2 Methodology

explanatory variables (X) of bank ownership (concentration and provenience) structure (24 banks in 2000 and 20 banks in 2008), that determinate quality of corporate governance were used to explain performance (Y) of banks, used as external measure of efficiency of corporate governance. Equations of the following structure were estimated:

$$Y = a + b_1 * X_1 + b_2 * X_2 + ... + b_n * X_n + e$$

where e represents error term. OLS was used. In case heteroscedasticity was present it was eliminated using Newey-West procedure. Statistical significance was evaluated through the following indicators:

- t-statistic: statistical significance of individual regression coefficients and regression constant;
- R2: success of the regression in predicting the values of the dependent variable within the sample; fraction of the variance of the dependent variable explained by the independent variables; explanatory level is not very high, which is reasonable for cross-section analysis;
- F- statistic: statistical significance of the equation.

The regression analyses of cross-section data for the years 2000 and 2008 shall be presented and compared which enables identification of determinants of successful corporate governance and changes that occurred throughout last decade.

3.2.3 Results of regression analyses for years 2000 and 2008

the estimated equations are presented in Tables 5 and 6. Performance indicators have been regressed on indicators representing ownership

Table 6: Influence of corporate governance on performance of banks, Slovenia, 2008.

Eq.	Y		C	X_1	X_2	X_3	R^2	F
1-2008	ROE		-8.05 (-2.59)	7.50*OM (6.16)	6.28*LASTD (2.12)	-3.52*LASTD*OM (-2.87)	0.53	6.12
2-2008	OM		2.59 (8.13)	-0.70*LAST1O (-1.52)			0.11	2.30
3-2008	ROA		-1.03 (-2.06)	0.83*OM (3.12)	1.08*LASTD (2.16)	-0.68*LASTD*OM (-2.53)	0.53	6.02
4-2008	S/A		2.63 (6.89)	-1.29*LAST1O (-2.33)			0.23	5.43
5-2008	S/A		3.01 (6.93)	-2.54*LAST1O (-2.71)	0.98*LASTT (1.62)		0.33	4.28
6-2008	S/A		2.90 (6.91)	-2.31*LAST1O (-2.55)	0.84*LASTTO (1.40)		0.31	3.84
7-2008	CAR		14.74 (11.11)	-0.00004*S/Z (-2.20)	-1.13*LASTTO (-1.48)		0.25	2.91
8-2008	CAR		14.60 (11.17)	-0.00004*S/Z (-2.14)	-1.03*LASTT (-1.39)		0.24	2.76
9-2008	A/Z		14719.9 (3.02)	-4231.1*S/A (-2.158)	-39210.9*LASTTO (-1.77)		0.42	6.36
10-2008	A/Z		-2956.4 (-1.00)	-13920.4*LASTT (-2.53)	22508.6*LAST1O (2.63)		0.55	10.3
11-2008	A/Z		-1951.6 (-0.83)	-13525.8*LASTTO (-2.57)	21099.6*LAST1O (2.71)		0.54	9.95
12-2008	LAST1O		0.40 (7.40)	0.53*LASTT (6.20)			0.68	38.43
13-2008	LAST1O		0.86 (16.07)	-0.54*LASTP (-6.77)			0.72	45.89

Source: Financial Statements of Banks in 2000 and 2008; Ljubljana: ZBS, 2001, 2009; own calculations.

structure and (indirectly) corporate governance as well as some other variables explained in detail in Table 4. Interpretations focus on role of corporate governance indicators for bank performance.

ROE was determined with market share and ownership concentration in 2000: increase in concentration (with statistical significance just above 0.1), ceteris paribus, is connected with 0.26 percentage point increase in ROE, while increase in share of foreign ownership by one percentage point decreases ROE by -0.07 (1-2000). In 2008 banks owned by the State had in average higher ROE than other banks (1-2008).

In 2000, ROA was in average lower in banks owned by foreigners (5-2000) and higher in banks in private domestic ownership (6-2000), while in 2008 ROA was on average higher in state owned banks (3-2008).

In 2000, costs per employee were higher in banks with foreign ownership (2-2000, 3-2000) and banks with higher ownership concentration (3-2000).

The share of costs in total assets (S/A) in 2000 on average increased by 0.01 for one percentage point increase in five biggest shareholders' share (4-2000). Conversely, ownership concentration was connected with higher cost efficiency in 2008: if share of first owner increases by one percentage point, S/A falls by 1.3-2.3 percentage points (4-2008, 5-2008, 6-2008). Cost inefficiency of foreign ownership persisted: foreign ownership was in average connected with a 0.98 percentage point higher share of costs in total assets (5-2008). Similar were results if percentage share of foreign ownership was used (6-2008).

In 2000, CAR was in average lower for banks owned by the state (13-2000), while in 2008 it was in average lower for banks owned by foreigners, although p-values in these cases slightly exceeded 0.1 (7-2008, 8-2008).

Foreign ownership reduced labour productivity measured by assets per employee (A/Z) in 2000 (14-2000) as well as in 2008 (9-2008, 10-2008, 11-2008). Increase in ownership concentration (share of first owner) is connected with higher labour productivity (10-2008, 11-2008). As explained already in 2.1.2 higher concentration of ownership (LAST1O) was characteristic for banks in foreign ownership in 2000 (9-2000) as well as in 2008 (12-2008), while similarly concentration

of ownership (share of first owner) was in average lower in case of private domestic ownership (10-2000, 13-2008).
Interest rate margin (OM) was lower in banks with higher concentration of ownership (2-2008).
Secondary emission (share of loans to non-banks in deposits to non-banks) was higher in case of banks with a higher percentage of foreign ownership (8-2000), which is reasonable since those banks enjoyed support of their parent undertakings and could tap other types of financing besides deposits.
Labour profitability (PROF/Z) in 2000 was in average higher in privately owned domestic banks (7-2000). Banks owned by the state had higher market share (11-2000) and privately owned domestic banks lower market share (12-2000).
Specifications for 2008 using same explanatory variables did not produce statistically significant results.

4. Conclusion

practically all performance indicators demonstrate that banks in foreign ownership (their number increased by 100% in last decade) continue to perform less efficiently or their efficiency has even further deteriorated. On the other hand, it is possible to notice that the banks with higher concentration of ownership demonstrate greater efficiency in comparison with the banks with diffuse ownership, which is especially evident in 2008. This result could be explained with consolidation of ownership witnessed between 2000 and 2008, when the average share of the largest owner increased from 46% to 70%. Ownership cumulated around two frequency peaks (30 - 40% and above 75%). Increased possibility of owners to influence bank management apparently improved their corporate governance.

In comparison, larger ownership concentration and higher share of foreign owners and fund owners in 2008 than in 2000 in Slovenia contributed to bank credit expansion and increased monetization, higher cost efficiency, but lower profitability and solvency in conditions of lower interest rate margins. These are results only of partial causality analysis as 2008 already marks the beginning of a global financial crisis.
Paul Wooley (2010) goes even so far to proclaim inadequate corporate

Concentrated ownership raises some corporate governance problems.

governance of banks in the form of unsolved principal-agent problem as major cause of global financial crisis. For him, solution is in redefinition of contracts between principals and agents in banks and other financial institutions so that the agents could not misuse the advantage of asymmetric information anymore to privatise profits (with help of mispricing and rent seeking). His suggestions for improvement of situation are to restrict agents by principals (owners, investors) in their activities by following actions:

- accept long-term investment strategy, because mark-to-market valuation is misleading and procyclical,
- restrict yearly turnover of portfolio to 30% (withholding tax exceptions if more)
- do not pay bonuses for performance, and apply stable guidelines for performance evaluation of managers,
- exclude alternative innovative instruments (derivatives); instead state securities should be issued to stabilise the financial system,
- require full transparency of banking and financial services performed and balances of banks, and management actions of financial institutions: costs, trading, loan strategy.

These proposals could be beneficial for corporate governance of Slovenian banks as well.

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Corporate governance in the Slovenian banking sector: an empirical survey

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CORPORATE GOVERNANCE IN THE SLOVENIAN BANKING SECTOR: AN EMPIRICAL SURVEY
In this paper we analyse corporate governance practices in Slovenian banking sector. We rely on the survey data[1] collected from 17 out of 19 banks incorporated in Slovenia at the end of 2009 and on the publicly available information on corporate governance practices in the banks. The main findings reveal that corporate governance institutional settings are well established and therefore the preconditions for the implementation of sound corporate governance principles in banks are met. The two-tier governance structure with a supervisory board and a management board clearly prevails. Members of supervisory boards are adequately qualified and highly competent. On behalf of the supervisory boards the audit and risk committee are the most frequently implemented committees. As one of the most challenging areas for the future development of corporate governance in banks we identify the need for more clearly pronounced alignment between executive compensation system on the one side and long run risk adjusted performance on the other hand.

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Due to the explicit and implicit loss protection of depositors by the deposit guarantee schemes and governments, moral hazard problem in the banking sector is more severe than in other financial industries and especially more severe than in the non-financial sectors. In particular, financial crisis made many to believe that bank shareholders and managers are inclined to greater risk taking than in other firms.

Introduction

Also, many of the recent studies have confirmed that risk governance, remuneration and alignment of incentive structures, board independence, qualifications and compositions as well as shareholder engagement represent the weakest governance areas that contributed to the severity of the last financial crisis (Ard and Berg, 2010). Generally regulatory authorities seek to make governance mechanisms more effective not primarily because of shareholders, but especially because of depositors. The effectiveness of corporate governance (CG) system may be judged in terms of its meeting the regulator's concern for depositor's funds and not only through the lens of shareholders wealth maximization (Sinha, 2006). Corporate governance mechanisms should ensure that greater incentives for risk taking coupled with potential financial incentives provided to bank managers (Houston and James, 1995, p. 406) do not endanger liquidity and solvency of the bank at the risk of all stakeholders.

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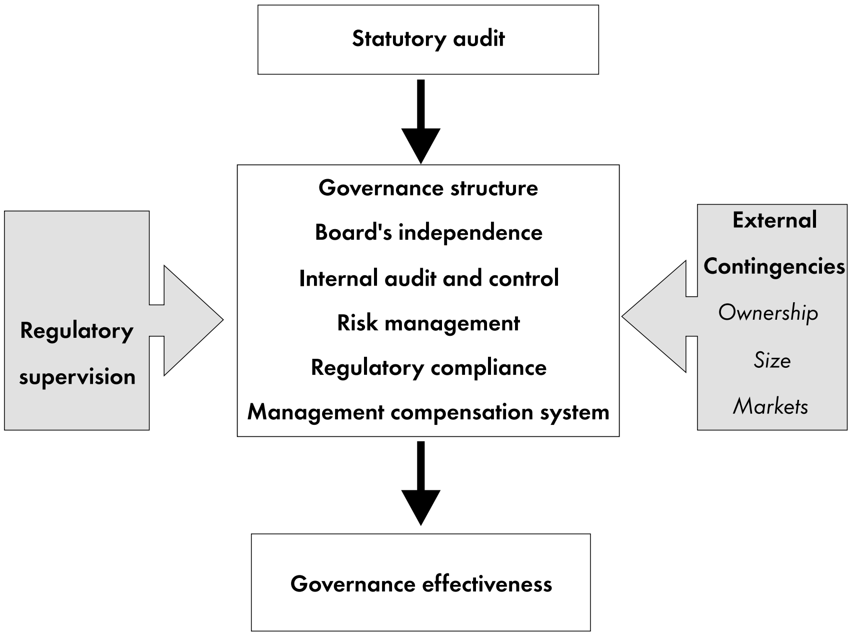
[1] We would like to thank Emil Lah and the Slovenian Bank Association for the help in distributing and collecting questionnaires and exerting all the effort that questionnaires were completed in time and with broad participation of the banks.

Figure 1: The factors influencing corporate governance effectiveness



Despite the large interest in the corporate governance of banks in general and during the financial crisis in particular, it is remarkable how little insight in the best practices of corporate governance mechanisms is provided by the literature for this sector. Collectively, the arrangements that delineate an effective corporate governance system in the banking sector are governance structure, risk management, internal audit and internal controls, statutory audit, compliance to regulation and incentive system of executive and non-executive directors (see Figure 1).
While in 2009 the Slovenian banks were for the first time subject to individual senior executives pay disclosure, the availability of other data to investigate corporate governance practices is critical due to confidentiality of the data. This study provides descriptive evidence on corporate governance practices in the Slovenian banks. In August and September 2010 the authors in cooperation with the Slovenian Bank Association conducted a survey that was targeted at the entire population of 19 commercial banks incorporated in Slovenia. In the survey we separately addressed supervisory (SB) and management boards (MB). We received 14 completed questionnaires from the supervisory boards and 17 from the management boards. The questionnaire attempted to capture a comprehensive set of corporate governance activities and other specifics of banks related to those activities. The questions covering corporate governance practices were compiled from the relevant literature on banking and corporate governance in banks (Hau & Thum, 2009, Fahlenbrach & Stulz, 2009), OECD questionnaires and survey findings (2006, 2009), but essentially they were based on our own experience[2]. Additionally, we also collected some relevant information on corporate governance practices in Slovenian banks by using their publicly available annual reports and information published on their web pages.
Competences, work experience, education and independence of SB members are the most important preconditions for an effective execution of supervisory role. We provide an overview of these characteristics. Furthermore, we are interested in modus operandi of SBs – i.e. in which committees they carry out their supervisory role, which functions they perform in each of the committees or on general meetings and what type of issues they most frequently deal with. While a lot of attention by the regulators is paid to compliance with regulation, governance structure, risk management, internal audits and internal controls, many notable bank failures worldwide happened because of human incentives which have not been considered as one of the major risks of a bank industry.
We look at the structure of performance measures used for compensation, the compensation system for executive directors and the extent to which the recent CEBS' recommendations on remuneration practices in the financial sector are being implemented by the banks.
The remainder of this study is structured as follows. Section 1 describes the results of supervisory boards' activities, in section 2 we present the perspective of executive board on own compensation system and section 3 concludes.

1. The activities of supervisory boards

1.1 The characteristics of the supervisory boards (SB)

Contrary to the best practices on transparency of governance, data on competences and personal characteristics of the SB members could not be retrieved from public sources. Only three out of 19 banks present details on SB members' competences in their annual reports or web-pages. We collected the information via questionnaires and they refer to 14 banks. This section of the questionnaire is to a large extent based on the questionnaire of SB competences

[2] Two of the authors have been serving as a member of a supervisory board and as a member of an audit committee in two of the banks.

Table 1: Distribution of age of SB members

Age group	< 35	36 - 40	41 – 45	46 - 50	51 - 55	56 - 60	61 - 65	> 66
% of SB members	4.6%	7.1%	17.4%	16.2%	16.6%	5.5%	17.3%	12.3%

Table 2: Education of SB members

	Business / Economics / Finance	Law	Social Sciences	Natural Sciences and/or Technology
Bachelor degree	41.0%	5.6%	0.0%	2.6%
Master degree	24.9%	2.6%	0.0%	1.2%
Ph.D.	15.5%	4.1%	0.0%	1.4%
Total	81.4%	12.4%	0.0%	5.2%

Table 3: Work experience in the financial sector – share of SB members that have...

... a work experience in the banking industry	54.0%
... a work experience in asset management, securities trading or financial management of firms	53.7%
... a prior work experience in the bank in which they are appointed as supervisory board members	8.9%

Table 4: Managerial work experience – share of SB members that have...

... a management consulting experience	38.8%
... a mid-level management experience	71.5%
... an executive-level financial management experience	23.7%
... an executive-level bank management experience	26.3%
... an experience as supervisory board members elsewhere	85.8%

by Hau and Thum (2009) for German banks.

The key characteristics for the SBs in those banks were in 2009 the following: The average number of SB members is 6.5 with the range from four to ten members. For comparison, according to de Andres and Vallelado (2008) who studied the role of the board of directors in the banking industry in six OECD countries the average board size ranges from 14.7 for Spain to 19.7 for Canada. Note however, the figures are not quite comparable due to the size differences in the OECD countries and in Slovenia. More importantly, de Andres and Vallelado (2008) find the inverted U-shaped relation between bank performance and board size, which means that the size of the boards represents a sensitive corporate governance issue.

Concerning the age structure, 50% of the SB members in our survey are from 41 to 55 years old and the age distribution is clearly skewed towards elder age groups (see Table 1). Both findings indicate that more experienced SB members prevail. As argued by Hau and Thum (2009) educational background is very important for the monitoring ability of SB members in banking where judgment on a particular issue often requires a high degree of financial literacy. We find that 81.4% of SB members are trained in business or economics, 12.4% in law and 5.2% in natural sciences and technology. The obtained academic degree is in general very high: more than 50% of the members have obtained higher than bachelor degree and 21% of them a Ph.D. (see Table 2).

Effective monitoring of banks requires industry-specific or related experience. Only about more than half of the members have relevant experience in this respect (see Table 3).

Managerial experience also provides SB members with the skills necessary to monitor top managers and processes of banks. In majority of cases board members hold or held positions of mid-level managers, but also of SB members of other organizations (see Table 4). Only slightly above a quarter of them have had executive level bank management or financial management experience.

We were interested in how the SB members got their mandate. On average 77% of them were proposed to the SB by the majority owner, 31% by the previous SB, 8% by the management board and nobody by the minority shareholders. One of the most important tasks of the SB is to appoint the executive management board (MB). 46% of the MB members are appointed on the proposal of the majority owner, 42% by the previous SB and 33% by the previous MB. The percentages do not add up to 100% as some of the MB members may have been proposed by more constituencies. None of them was appointed on the proposal of the minority shareholder.

The effectiveness of the SB is hard to measure. Despite of its biases, self-evaluation of the SB is one of the ap-

proaches that have been acquiring importance in the recent years. 57% of the SBs have performed self-evaluation in 2009. 50% of the SBs have responded positively to the question that their members participated in trainings to acquire or improve skills necessary to supervise a bank.
Certain membership stability is definitely a desirable feature of the SBs, although it is even more important that SB members avoid situations when the integrity of their work in SB could be compromised. In 2009, on average 18.5% of SB members were replaced. In most of the cases the reason for replacement was resignation of the member(s), in one case the change of ownership, in one case the conflict of interests because the member overtook other duties and in one case the reason for replacement was death.
We were also interested in the number of the independent members as determined by the Bank of Slovenia Regulation on the diligence of members of the management and supervisory boards of banks and savings banks (Official Gazette of the RS, n. 28/07 and 70/09). In the questionnaire 83.2% of the SB members were defined as independent. Our estimation based on public information gives a significantly different answer. We do not consider a SB member who is affiliated (being an employee or SB member) with one of the major owners of the bank to be an independent board member. According to such definition and publicly available data, the share of independent members is 62.5% on average. On average only 3.6% of the SB members have been designated as representatives of the government (ministries) or established members of the political parties. In majority of the banks that number was zero, and interestingly, the number of politically independent members does not depend on the ownership of the bank (state versus private).
50% of the responding SB members have no liability insurance, in 16.7% only some of them are covered and in 11.1% (i.e. two banks) all SB members have liability insurance.

1.2 Modus operandi of the SB

On average SBs held 6.6 regular meetings in 2009, while the range was from four to twelve. Additionally, on average 3.4 correspondence meetings took place (in the range from zero to ten). The SBs perform monitoring in various specific committees. The most recent corporate governance principles for the banking industry released by the BIS (BIS, 2010) propagate apart from audit and risk committee three further committees that have become increasingly common among banks: compensation committee, nominations/human resources/governance committee and ethics/compliance committee. According to the results in our survey all 14 banks have an audit committee as required by the Banking Act, 21% of the banks have a risk committee and 29% of the banks have a compensation committee. Five of the banks report the existence of a nomination committee and two other specialised committees.

Effective monitoring of banks requires industry-specific or related experience.

In the business where privacy of information, bank's reputation and relationship with clients is very important, behaviour of employees cannot be entirely prescribed by the internal or legal rules. 64% of the banks define desired behaviour by an ethical code and in 83% of responding banks a major violation of the ethical code of conduct represents a violation of the employment contract.
Modus operandi of an SB among others also depends on the corporate strategy of the bank. Despite of a severe economic downturn in 2009 and a statistically reported stagnation in credit activity of the banking sector (especially regarding corporate operations), 64% of the 14 banks indicated that they pursue a growth strategy, while 35% of them follow stabilization and consolidation strategy. Doing business in socially and environmentally responsible way addresses the needs of other stakeholders of the bank, which coincides with the scope of corporate governance of banks in general. From the publicly available annual reports we retrieved that 89% of all 19 banks have some form of corporate social responsibility policy which they report. In the annual reports we have not noticed that any of the banks conducts business in line with the sector specific Global Reporting Initiative or the Equator principles, the most relevant principles of social responsibility given the characteristics of the financial service sector.
We asked SBs to indicate the frequency (and importance) of the topics discussed during the meetings of the SB in 2009. The most frequently discussed issues were related to 1) approval of the resolutions of various SB committees and annual report, 2) selection of the statutory auditor, 3) bank's strategy and annual plan, 4) overview of performance and control system of subsidiaries and 5) capital adequacy and regulator's recom-

Table 5: Education of the AC members

	Business / Economics / Finance	Law	Social Sciences	Natural Sciences and/ or Technology
Bachelor degree	38.5%	2.4%	0.0%	1.4%
Master degree	40.2%	0.0%	0.0%	0.0%
Ph.D.	17.5%	0.0%	0.0%	0.0%
Total	96.2%	2.4%	0.0%	1.4%

Table 6: Work experience in accounting, auditing, finance and internal control

Share of the audit committee that have working experience in accounting, auditing or internal auditing	59.5%
Share of the audit committee members that hold one of the professional certificates of the Slovenian Institute of Auditors (or foreign equivalent certificate) (CFA, CPA, CMA, a certified controller, a certified accountant, a certified auditor, a certified company evaluator etc.) or the equivalent formal education of the field?	32.0%

Table 7: Managerial work experience – share of audit committee members that have...

... a management consulting experience	41.3%
... a mid-level management experience	65.4%
... an executive-level financial management experience	32.9%
... an executive-level bank management experience	22.3%
... an experience as supervisory board members elsewhere	67.1%

mendations and measures. There was no variation in the importance of these issues – in the each of the responding banks these issues were always discussed during sessions of SB. The least frequently discussed issues were 1) critical individual loans (surprisingly) and 2) appointment of new executive managers. However, there is a very large variation in responses regarding these two topics, which indicates that importance of these issues varies considerably among banks.

Below we focus on the supervisory functions performed by the audit committee. We do not report descriptive statistics for risk and compensation committees since the number of responses (three and five, respectively) is not representative of the whole sample.

1.2.1 Audit committee

On average audit committees have 3.36 members, but they range from three to five. Their academic background is predominantly from business and economics. A significantly higher share of members (see Table 5) has master degree or a Ph.D. in economics and business than the members of SB in general.

For AC members that monitor accounting policy, choice of accounting methods, internal controls and similar functions specific experience is important, in particular of accounting, auditing and internal control. Almost 60% of the members have that kind of experience and 32% hold one of the professional certificates that prove extensive training in the field (see Table 6).

Most of the AC members have an experience as SB members in another corporation and/or as mid-level managers (see Table 7).

ACs held in average 4.2 regular meetings in 2009, the maximum number of meetings was nine, but the minimum was zero which in other words means that one bank does not comply with the legal and professional requirements. In addition 0.36 of a meeting was held as a correspondence meeting. In 77% of the cases the head of internal audit is always present in the meetings of the audit committee in only sometimes in 23% of surveyed banks. There were no occasions where internal auditor is only rarely or never present in the meetings. Out of 13 valid answers to the question "*How frequently the audit committee meets the external auditor without the presence of the management board?*" 46.2% of the respondents indicated that this is never the case, 23.1% responded that this happens once a year and 30.8 % responded that this is two or three times a year. It should be noted that occasional meetings between the audit committee and the internal and external auditors without the presence of the management board are recommended by the Code of Corporate Governance and the Recommendations for the Audit Committees (published by the Slovenian Directors' Association, 2009).

Great variability is evident from the responses on the question of the average duration of the audit committee's meetings. They lasted from one to seven hours and 2.7 hours on average. On average the surveyed banks use the same audit firm for six years, but in two extreme cases banks have been using the same auditing firm since 1990 and 1993. The Corporate Governance code recommends that at least once every five years the company commissions another key audit partner at the

Table 8: Compensation in 2009

	N	Minimum	Maximum	Mean	Std. Deviation
Gross receipts of management board without severances	19	167,000	1,242,000	591,182	323,850.20
Bonus of management board	16	0	320,000	101,290	117,226.21
Fixed pay of management board	16	144,932	1,168,000	466,379	251,967.15
Share of performance-pay in gross receipts of management board	15	0.0	0.38	0.13	.12
Average gross receipts per MB member	19	46,875	411,084	191,704	101,086.13
Gross receipts of CEO	19	13,000	417,000	217,168	108,573.03
Bonus of CEO	19	0	173,000	32,270	48,924.65
Fixed pay of CEO	19	13,000	389,333	184,898	89,002.80
Average gross receipts per supervisory board member	19	0	38,600	9,608	10,500.92
Ratio between gross receipts of MB and SB member	15	5	183	31.1	44.452

same audit firm or hire a different audit firm. On average in the surveyed banks the same lead audit partner has been commissioned since 2008. We have not observed any violation of that CG Code requirement, since at the earliest the partner took over in 2005 (hence, the 2009 is his/her fifth year). Auditing of the banks has been performed primarily by the "Big four" companies with one exception (data for all 19 banks come from publicly available information): Deloitte covers 21.1% of the market share, Ernst & Young holds 21.1% share, KPMG 21.1%, PWC 31.6% and UHY holds 5.2% share of the market.

Respondents were asked to indicate the frequency (importance) of the topics discussed during the meetings of the audit committee. Most frequently discussed issues were related to 1) statutory audit of financial statements, 2) quarterly reports of the internal audit, 3) annual plan of the internal audit and 4) measures taken as a response to the requirements of the regulator. The least frequently discussed topics were 1) IT solutions and independent audit of the IT system, 2) compliance report and 3) individual investments that have considerably negatively affected the financial performance of the bank. However, there is also a very large variation in responses these issues, which indicates that importance of those issues varies considerably among banks.

2. Compensation policy

2.1 Executive compensation policy in numbers

There is little dispute over the fact that performance-related pay schemes affect individuals' risk-seeking behaviour. First, performance-related pay rewards positive performance far more than it punishes negative one. Second, under traditional bonus system managerial performance is almost never indexed by the general market rises, for which it booms rewards and induces excessive risk seeking in good times while outcomes of those decisions may extend to the period of economic downturn and have extremely negative consequences. We retrieved the information on the compensation of MB and SB from the annual reports for all 19 banks (see Table 8).

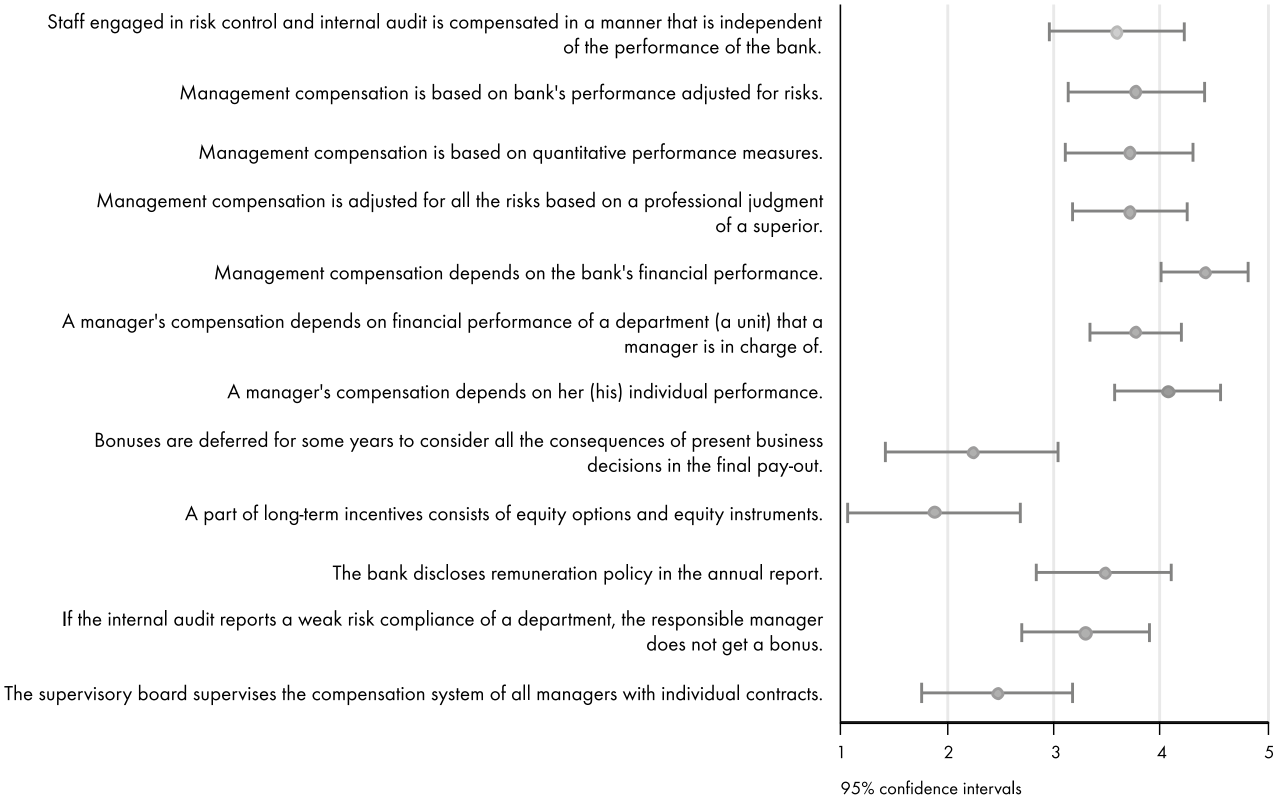
The average pay of a board member amounted to 191,704 EUR (without any severances), which is above the average of MB pay for companies listed on the Stock Exchange that amounted to 158,512 EUR[3].

Only a small fraction (13%) of total pay is performance-dependent. This suggests that compensation design of the MB in Slovenia is not in contrast with the recent recommendations of the regulators (such as CEBS, European CG form) about a moderate ratio between fixed and variable pay and pay caps, although the low percentage may well be ascribed to pay-outs during the crisis. Nevertheless, the variability in the sample is large. However, it remains debatable whether 13% of performance-related pay provides enough room to stimulate desired level of risk taking and to penalise managers because of violations of internal procedures, negative evaluations of certain procedures by the Central Bank or excessive risk taking.

Average gross receipts for the SB members amounted to 9,608 EUR, whereby the variability of pay to SB members is much smaller than to MB members. In three of the banks SB members (or non-executive members of a one-tier board) do not get any fee for service as they are employees of the parent company. The ratio between the pay of the MB member to an SB member is 31.1 : 1. A general recommendation of best CG practice is that an appropriate amount of work for the president of the SB

[3] The estimate is based on the publicly disclosed information.

Figure 2: The perception of MBs on compensation policy



equals to one month of monitoring activities and such should also be the pay ratio between CEO and her/him (12 : 1).

2.2 A managerial view

In a discussion in the IMF's quarterly magazine Rajan (2005) provides an overview of the issues in the internal governance of banks that may be considered crucial for the proper governance and control of banks. Indeed, the central thesis of this discussion note is that such internal governance mechanisms determine its overall, i.e. outside, risk profile of the bank. His analysis makes it clear that the design and the use of systems that are supposed to motivate managers to enhance performance through evaluation of their performance and rewarding determine an individual's attitude toward risk seeking behaviour. This issue is of even greater importance during the financial crisis.

We were therefore interested in the perception of the compensation policy by MBs. In the survey CEOs were asked to indicate on a scale ranging from 1 ("I completely disagree") to 5 ("I completely agree") to which extent they agree with the statements about the state of compensation related issues in the bank in the current year (2010). In CEOs in general perceive that their compensation in the bank in 2010 is based on performance (they agree most with the statement that compensation depends on bank's financial performance), adjusted for risks. CEOs quite strongly perceive that they are rewarded for their individual results, but also for the team (bank-based) results. Although there is in general little variation in the answers provided, there is more variation when it comes to deferral of bonuses and option compensation. CEOs' answers on average show that bonuses are not being deferred and that they are not in the form of equity options and equity type of financial instruments. In contrast to general evidence, CEOs of three surveyed banks are compensated in equity options and in the two of those cases bonuses are deferred as well. In most of the surveyed banks SBs do not supervise the compensation system for all managers with individual contracts. Figure 2 we present the 95% confidence interval for the answers related to the compensation policy. CEOs in general perceive that their compensation in the bank in 2010 is based on performance (they agree most with the statement that compensation depends on bank's financial performance), adjusted for risks. CEOs quite strongly perceive that they are rewarded for their individual results, but also for the team (bank-based) results. Although there is in general little variation in the answers provided, there is more variation when it comes to deferral of bonuses and option compensation. CEOs' answers on average show that bonuses are not being deferred and that they are not in the form of equity options and equity type of financial instruments. In contrast to general evidence, CEOs of three surveyed banks are compensated in equity options and in the two of those cases bonuses are deferred as well. In most of the surveyed banks SBs do not supervise the compensation system for all managers with individual contracts.

A second issue that we were interested in was the composition of the compensation matrix (performance criteria). CEOs were asked to indicate to what extent their compensation is based on 1) financial performance, 2) risk measures, 3) operational measure and 4) soft performance indicators (i.e. % of weight that certain performance criteria contribute to overall compensation). The summary of responses given by the CEOs is presented in Figure 3. From the figure we observe that financial performance (accounting measures such as ROA, ROE, EPS, etc.) is the most important element of performance evaluation, making up to almost half of the weight in overall evaluation on average. Other three performance areas are on average given similar importance (between 15 and 20 percent). Given the general practices of the last ten years regarding managerial compensation in the financial sector, it does not come as a surprise that risk measures do not have significant impact on the compensation. However, comparison of CEOs perceptions of compensation policy (see Figure 2) and CEOs responses regarding the importance of different elements of compensation matrix (see Figure 3) reveals a potential discrepancy. While CEOs on average agree that their compensation is based on bank's performance adjusted for risks, risk measures are on average significantly less important than financial performance when it comes to the actual relevance for their compensation. A more careful investigation reveals that in few of the surveyed banks financial performance carries a very high weight, while in most of the banks financial performance and risk measures carry similar weights in the compensation matrix. This suggests that observed discrepancy between the results in Figures 2 and 3 is driven by few extreme cases and that the result regarding the importance of risk measures is consistent.

Two tier governance structure with supervisory and management board clearly prevails.

2.3 A supervisory view

We asked the SBs the same questions we posed to the CEOs regarding the characteristics of compensation policy in 2010. Given that we received responses on compensation from only nine SBs, we are not able to provide a valid comparison. However, some pattern does emerge from the comparison of responses given by SBs and CEOs. Firstly, CEOs and SBs tend to agree most when it comes to 1) measuring bank's performance on risk adjusted basis and 2) compensation based on bank's financial performance. Secondly, SBs more than CEOs perceive that MBs compensation is being based on quantitative measures. In other words, this indicates that in some cases managers do not see their compensation being based on quantitatively established performance measurement, while their SBs believe that MBs compensation is set according to a quantitative measure.

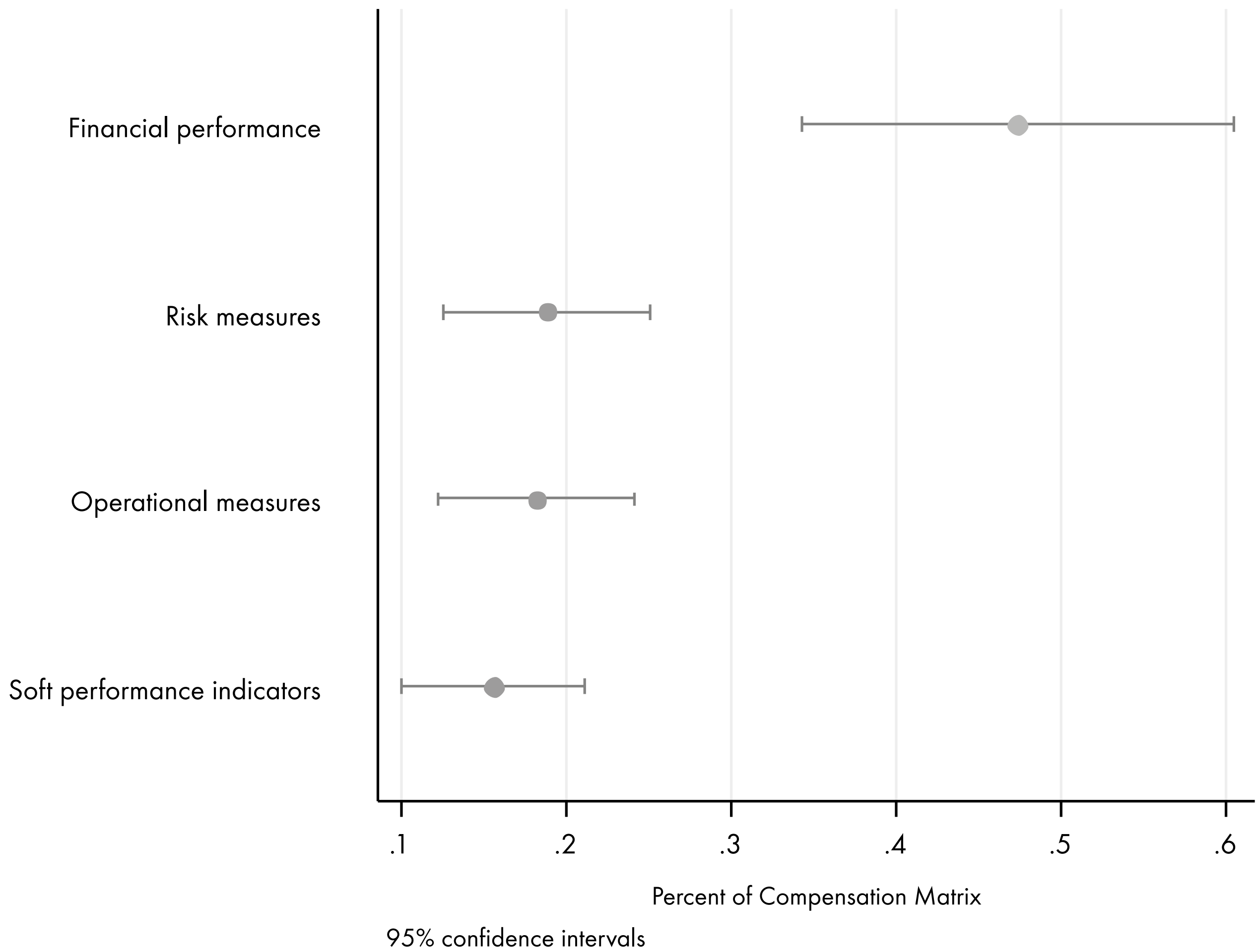
In terms of the structure of the compensation matrix most of the responses of SBs and CEOs were the same. This leads us to conclude that banks seem to have clearly stated policies regarding the measures taken into account when determining the compensation of managers. The exceptions to this finding are those banks where SBs and CEOs disagree most whether managerial compensation is based on quantitative measures.

3. Conclusion

The purpose of our study was to evaluate corporate governance practices in banks incorporated in Slovenia. We studied survey data collected from 17 out of 19 banks and the publicly available information on governance structure and managerial compensation in individual banks. The survey was structured on the basis of similar studies previously carried out in some OECD countries and on the basis of sound principles published by international institutions and standard setters in the field.

Limitations of the study arise from the fact that some questions in the questionnaires are perceptional. Perceptions of people in certain issues differ. This has become the most obvious for the answers on compensation system where same questions were asked to the supervisors and to the managers. Nevertheless, we believe that our sample of 14 supervisory boards (SBs) and 17 management boards (MBs) is representative of the current stage of development of

Figure 3: The composition of the compensation benchmark



corporate governance of banks in Slovenia. The banks that have not responded to the SB part of the questionnaire are four smaller privately-held banks, two of them foreign subsidiaries.

The main findings reveal that corporate governance settings are well established and therefore preconditions for the implementation of sound corporate governance principles in banks are met. The two-tier governance structure with supervisory and management board clearly prevails. Members of governing bodies are adequately qualified and highly competent. In the supervisory boards the audit committee is the most frequently implemented committee. This is not unexpected, since it is required by law. On the other hand, risk and compensation committees are very rare. This is not surprising given the relatively small size of the banks and the SBs, where particular issues are mostly discussed during meetings of the entire SB. However, the answers show a more recent tendency of SBs towards establishing risk and compensation committees.

Performance dependent compensation for MBs is used to a smaller extent, which is in line with recent CEBS recommendations. On the other side low performance-pay ratio reduces the power of the SBs and shareholders to reward or penalise promptly some of the decisions of the MBs. Although it seems that CEOs agree with compensation policies that account for risk adjusted performance, the decomposition of the compensation benchmark reveals a clear dominance of the financial performance over the risk measures component. In order to empirically confirm the contention that compensation policies formally include adjustments for excessive risk, one would need to empirically analyze the relationship between executive pay and risk in a multiperiod framework. This was beyond the scope of this paper. Despite of the recommendations on bonus deferrals from financial regulators, we find little evidence that banks implement such compensation practices. Furthermore, we do find some gaps between the perception of executive compensation by the SBs and CEOs. We therefore believe, that one of the most challenging areas in the future development of corporate governance in banks is the need for clearly pronounced relation between the implemented compensation schemes on one side and long run risk adjusted performance on the other.

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Overview of corporate governance of banks in south-eastern Europe

*Gian Piero Cigna and Roman Chapaev**

OVERVIEW OF CORPORATE GOVERNANCE OF BANKS IN SOUTH-EASTERN EUROPE
Corporate governance in banks differs from the "ordinary" corporate governance of companies. This is due to the nature of the banking business (i.e. dealing with money), the need for protection of the weakest party in the chain (i.e. the depositor) and the systemic risks that a bank failure might cause.
The banking sector in all countries in the south-eastern Europe is comparatively more advanced than the securities markets. In the large majority of countries in the region, stock exchanges are illiquid or characterised by limited trading. It follows that corporations have to rely on banks for their financing and development.
The article looks at the international standards on corporate governance for banks and provides an overview of legislation on corporate governance and banking with specific focus on the banks' management structure and disclosure requirements.
It concludes that banks are in a position in which they can influence the corporate governance of their corporate borrowers and they can become promoters of better corporate governance practices for all other companies.

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Recent years in the world of finance have been dramatic and turbulent, and they will not be remembered as the best years for the financial markets. In fact, the entire existence of the modern financial system at times appeared to be in jeopardy. According to the latest available estimates by the International Monetary Fund, the cost of write-downs in the banking sector alone amounted to US Dollars 2.3 trillion.[1] This estimate, of course, only partially reflects the aggregate cost of the crisis (which to a large extent was ultimately borne by the taxpayer) and the painful effects that were felt in the real economy.

1. Introduction

There are numerous papers that give account of the causes of the financial crisis. What causes of the crisis are often put forward in discussions? Financial product complexity (*e.g.* complex securitisations), lack of transparency, over-reliance on credit ratings, loose monetary policy, and regulatory lapses, to name just a few 'culprits'.[2] It is also often argued that the crisis was a complex event, with several causes operating at the same time. However, the discussion of the causes of the crisis is not the subject of this article. Instead, our analysis focuses on another specific area that, arguably, was an important contributing factor in the recent event: bank corporate governance. Corporate governance weaknesses in financial institutions were not *per se* the main causes of the financial crisis.

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[1] See 'Meeting New Challenges to Stability and Building a Safer System', April 2010 Global Financial Stability Report (Washington DC: IMF, 2010), p.xi. Available at <http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf>. In fact, the US Dollar 2.3 trillion figure was revised down from the earlier estimate of US Dollar 2.8 trillion.

[2] See, e.g., Walker, George A., 'Credit Crisis, Bretton Woods II and a New Global Response: Part 2', (2009) 2 Journal of International Banking and Financial Law 77.

However a more timely and effective mechanism of checks and balances in governance systems might have helped mitigate the worst aspects of the crisis. Indeed, the *financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements. When they were put to a test, corporate governance routines did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies.*[3]

Corporate governance is defined by the OECD as involving *a set of relationships between the company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.*[4] This definition is also endorsed by the Basel Committee on Banking Supervision (the "BCBS").[5]

In the banking sector, corporate governance was addressed at the international level by the BCBS long before the recent financial crisis.

In September 1999, the BCBS published the paper "Enhancing Corporate Governance for Banking Organisations"[6] in order "to reinforce the importance for banks of the OECD principles".[7] The 1999 Basel document was revised in 2006[8] and complemented in October 2010, with the release of the "Principles for enhancing corporate governance" (the "2010 Principles").[9] Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole. Poor corporate governance can contribute to bank failures, which can in turn pose significant public costs and consequences due to their potential impact on any applicable deposit insurance system and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems.[10]

The Basel 2010 Principles is a comprehensive document, which includes fourteen principles in six areas: board practices; senior management; risk management and internal controls; compensation; complex or opaque corporate structures; and disclosure and transparency.[11]

Finally, the Green Paper on "Corporate Governance in Financial Institutions: lesson to be drawn from the current financial crisis, best practices" should be mentioned as the EU response to the recent crisis.

In the present article we aim to review some of the EBRD's corporate governance regimes in the south-eastern Europe, taking into consideration and comparing the legislation and practices on the banks' management structure and disclosure. The research is "desktop-based", being based on publicly available information, and provides some preliminary findings of a larger analysis that the EBRD is performing in all the Bank's countries of operations and that will be published in 2011.[12]

Arguably, the corporate governance regime in a jurisdiction often consists of rules adopted at several levels: company law, securities markets legislation/listing rules (*i.e.* mandatory rules applicable to listed companies, including banks), corporate governance codes,[13] and sector-specific banking laws and regulations (*e.g.*, adopted by a national central bank). However, the analysis of corporate governance rules (*i.e.* the "law on the books") alone could not provide a complete picture of the corporate governance situation in a given jurisdiction.

Such analysis must be supplemented by an inquiry into how the rules are implemented. For this purpose, our legal analysis is supplemented by data gained by having a closer look at what banks disclose on their websites.

Brief overview of the banking sector in south-eastern Europe

The present analysis takes into consideration the legislation and practices on corporate governance of banks in some jurisdictions in the region.

The banking sector in all countries in the south-eastern Europe is comparatively more advanced than the securities markets. In the large majority of countries in the region, stock exchanges are illiquid or characterised by limited trading - see table 1 below. It follows that corporations have to rely on banks for their financing and development.

[3] Kirkpatrick Grant, 'The Corporate Governance Lessons from the Financial Crisis', Financial Market Trends, pre-publication version for Vol. 2009/1, available at http://www.oecd.org/dataoecd/32/1/42229620.pdf.

[4] OECD Principles of Corporate Governance (Paris: OECD, 2004), p.11. Available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

[5] See Basel Committee on Banking Supervision, Enhancing Corporate Governance for Banking Organisations (Basel: BIS, 2006), p.4. Available at <http://www.bis.org/publ/bcbs122.pdf>.

[6] 'Enhancing Corporate Governance for Banking Organisations', Basel Committee on Banking Supervision, September 1999 (Basel: BIS, 1999), available at <http://www.bis.org/publ/bcbs56.pdf>.

7 Ibid, at 1.

[8] 'Enhancing Corporate Governance for Banking Organisations', Basel Committee on Banking Supervision, February 2006 (Basel: BIS, 2006), available at <http://www.bis.org/publ/bcbs122.pdf>.

[9] 'Principles for Enhancing Corporate Governance', Basel Committee on Banking Supervision, October 2010 (Basel: BIS, 2010), available at <http://www.bis.org/publ/bcbs176.pdf>. Note that the 2010 BCBS paper does not replace the 2006 document, but '... [highlights] key areas where the Committee believes the greatest focus is necessary ...'.

[10] Ibid, at 5.

[11] Ibid, at 2-3.

[12] The European Bank for Reconstruction and Development (EBRD) is an international financial institution established in 1991 in response to major changes in the political and economic climate in central and eastern Europe. The EBRD's countries of operation are: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkey, Turkmenistan, Ukraine, and Uzbekistan.

[13] Here understood to be sets of rules that can be complied with voluntarily, but often also on a "comply or explain" basis for listed companies.

Table 1 - Stock Exchanges in the south- eastern Europe

Country	No of companies listed	Market capitalisation*	Average daily trading volume of stock*
Albania	Inactive	Inactive	Inactive
Bulgaria	392	7,472.83	1.38
Croatia	220	22,732.6	3.50
FYROM	73	2,506.45	31.13
Montenegro	59	3,670.57	0.11
Romania	166	29,659.82	7.89
Serbia	1,640	9,800.02	0.75

* in USD million
Source: Federation of Euro-Asian Stock Exchanges website (http://www.feas.org/MemberIndex.cfm) accessed on 14/10/2010. Data represent the 2010 estimate.

Table 2 - Banks and Foreign Capital Share

Country	Number of banks			Foreign capital share (in %)		
	2007	2008	2009	2007	2008	2009
Albania	16	16	16	91.33	91.92	93.12
Bulgaria	29	30	30	72.81	71.71	66.85
Croatia	33	33	32	90.8	90.6	90.1
FYROM	18	18	18	85.9	92.7	93.3
Montenegro	11	11	11	76	80	81
Romania	31	32	31	78.6	77.2	76.5
Serbia	35	34	34	77.3	79.1	77.7

Source: Banking Supervisors from Central and Eastern Europe website (http://www.bscee.org) BSCEE Review 2009

Table 3 - Ownership structure of financial institutions on basis of registered capital (%) (end-2009)

Type of financial institution	Albania	Bulgaria	Croatia	FYROM	Montenegro	Romania	Serbia
State ownership	0	16.46	3.2	8.0	3	12.2	12.0
Other domestic ownership	6.88	16.69	6.7	23.4	16	11.3	10.3
Domestic ownership total	6.88	33.15	9.9	31.4	19	23.5	22.3
Foreign ownership	93.12	66.85	90.1	68.6	81	76.5	77.7
Financial institutions, total	100.00	100.0	100.0	100.0	100.0	100.0	100.0

Source: BSCEE Review 2009

Table 4 - Ownership structure of financial institutions on basis of assets total (%) (end-2009)

Type of financial institution	Albania	Bulgaria	Croatia	FYROM	Montenegro	Romania	Serbia
State ownership	0	1.27	4.1	1.4	-	7.3	16.7
Other domestic ownership	6.74	14.60	4.9	5.3	13	7.4	9.0
Domestic ownership total	6.74	15.87	9.0	6.7	13	14.7	25.7
Foreign ownership	93.26	84.13	91.0	93.3	87	85.3	74.3
Financial institutions, total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: BSCEE Review 2009

As shown in table 2 below, banks in the region are characterised to a very large degree by foreign ownership, while state participation is extremely limited, with the notable exception of Bulgaria (partly due to the 2009 increase of the capital of the Bulgarian Development Bank) Romania and Serbia.

Albania

The Albanian banking sector comprises 16 banks, of which only two are owned by Albanian shareholders and only one of three major banks is domestically owned.

Legal Framework on Banking and Corporate Governance

The Law on Banks in the Republic of Albania enacted on 18 December 2006 set for the rules on the establishment, licensing, organisation, management and liquidation of banks in Albania. Specific corporate governance legislation - also applicable to banks - is comprised in the Law on Entrepreneurs and Companies enacted on 14 April 2008. The Law on the Bank of Albania, enacted on 29 April 1991, as subsequently amended, regulates the operations of the Bank of Albania, the authority in charge of regulation and supervision of the banking sector in Albania, while the Albanian Financial Supervisory Authority is responsible for supervision of the securities market, insurance sector and pension funds.

Bank's Management Structure

Joint stock companies in Albania have the option to choose either a one-tier or two-tier system. In the latter case, the managing directors can be elected and dismissed by the general shareholders meeting or by the supervisory board, as provided by the charter. The Law on Banks requires banks to be organised under a two-tier system, where the general shareholders' meeting appoints both a steering council and the members of the "directorate". The steering council is the bank's decision-making and supervisory body. At least one-third of its members must not be related to controlling shareholders or to the bank's executive directors. Members of the directorate can also sit on the steering council but they should not be its majority.
Banks are required to establish an audit committee made of three members with experience in accounting or auditing. They are appointed by the shareholders' meeting also from outside the steering council. The audit committee is responsible for the supervision of the audit, accounting procedures and internal control of the bank.

Specific Disclosure Requirements

The 2008 Bank of Albania Regulation "For the Minimum Requirements of Disclosing Information from Banks and Foreign Bank Branches" requires banks to maintain a website with relevant information and to publish – among others – information on their share capital; any capital increase, "qualified" shareholders; management structure, powers and responsibilities, qualifications and experience of directors; ownership structure, participation of main shareholders in the steering council or in the bank directorate; code of ethics and code or governance policy and bank policy in connection with conflict of interest, and related parties.

Disclosure Practices

When accessing the English version of the major banks' websites, it was possible to find annual reports including some limited information on the identity of directors, sometimes supplemented by a short biography and aggregate remuneration of directors. Annual reports do not include any specific section on corporate governance. Instead, it was not possible to find any copies of the bank's charters and bylaws, information on responsibilities and functions of directors and bank policies on conflict of interest, and related parties.

Bulgaria

The Bulgarian banking sector comprises 30 banks. The ownership of the three largest banks, which account for approximately 40 per cent of the aggregate value of assets of the Bulgarian banking sector, is highly concentrated and in the hands of foreign investors. None of those banks is listed on the Bulgarian Stock Exchange.

Legal Framework on Banking and Corporate Governance

Corporate governance legislation in Bulgaria is essentially comprised in the Commerce Act, the Law on Public Offering of Securities ("LPOS"), the Accountancy Act and the Law on Financial Independent Audit. Further, a Bulgarian National Code for Corporate Governance was issued[14] in October 2007. The Code includes a set of recommendations for Bulgarian listed companies to be adopted on a "comply or explain" basis.[15]

Bank's Management Structure

Bulgarian companies, including public companies and banks, can opt for a one-tier system (board of directors only) or a two-tier system (supervisory board and management board). In line with Art. 41 of the 8th EU Company Law Directive, the Law on Financial Independent Audit requires "public interest companies" (including banks) to establish an audit committee. In listed companies and banks one-third of the board directors must be independent. Detailed rules on independent directors are included in the National Code of Corporate Governance. Finally, the Law on Credit Institutions promulgated in July 2006 requires banks to regularly review their organisational structure and the procedure for defining and delegating powers and responsibilities of directors.

[14] <http://www.ebrd.com/downloads/legal/corporate/bulgaria code.pdf>.

[15] The Law on Public Offering of Securities (adopted 1999, as amended), Article 100m, requires the issuers to disclose in their annual financial statement "programme for application of the internationally recognized good corporate governance standards, specified by the deputy chairman" and annual reports should also include information on "compliance of the operation of the issuer's management and supervisory bodies during the past year with these standards" (<http://www.fsc.bg/media center/files/sk1.pdf>).

Specific Disclosure Requirements

Apart from the reporting duties to the National Bank, the Law on Credit Institutions establishes detailed rules for disclosure of key corporate governance documentation and practices such as financial results, information on shareholder meetings, disclosure of conflicts of interests and for maintaining transparent shareholder structure within the banking sector. The LPOS requires banks to disclose a corporate governance improvement plan in their annual report. An identical requirement exists in the National Code of Corporate Governance and is applicable to listed banks.

Disclosure Practices

Although the listing rules of the Bulgarian Stock Exchange require listed companies to declare their compliance with the Code, the Stock Exchange does not scrupulously monitor such disclosure. "*Regretfully, even though there has been a significant improvement in the legal framework on corporate governance, compliance is mostly with the form of the requirements and to a much lesser extent with their essence*".[16]
When accessing the English version of the major banks' websites, we have found names and biographies of the members of the board, financial and annual reports and in some cases the corporate social responsibility report, with a section dedicated to corporate governance. Instead, we could not find information on independent directors, composition of board committees or the banks' charter and board committees' bylaws.

Croatia

The Croatian banking sector comprises 39 credit institutions: 32 banks, two savings banks and five housing savings banks.[17] The three largest banks represent approximately 54 per cent of the whole banking sector. All three are listed on the Zagreb Stock Exchange, their ownership is concentrated and in the hands of international investors.

Legal Framework on Banking and Corporate Governance

Corporate governance legislation in Croatia is essentially comprised in the Companies Act, while banks operate according to the Credit Institutions Act.
A voluntary Corporate Governance Code has been adopted by the Croatian Financial Services Supervisory Agency and the Zagreb Stock Exchange in April 2007. The Code focuses on disclosure, shareholder general meetings, management and supervisory boards, and covers many issues in line with the OECD Principles. Listed companies are required to state in their annual report and on their website whether they comply with the Codeor state the reasons for non-compliance.

Bank's Management Structure

The Companies Act allows joint-stock companies to choose between one- or two-tier board systems. According to the Credit Institutions Act, banks are required to have a management board and a supervisory board.
The Act requires the supervisory board to have at least one independent member. There are no specific requirements to have board committees, although the Act expressly includes reporting duties by internal audit to the audit committee. On the other hand, the Corporate Governance Code recommends boards in listed companies and banks to set the appointment, remuneration and audit committees, made of a majority of independent directors. It should also be mentioned that the Croatian National Bank has the authority to order a credit institution's supervisory board to appoint appropriate committees for specific areas of operations.

Specific Disclosure Requirements

Apart from the ordinary reporting duties to the regulator, banks are required to adopt a policy on public disclosure and the Credit Institutions Act details a list of issues that banks are required to disclose on their website. Unfortunately, the list does not include corporate governance relevant information other than risk management objectives and policies. As a result, only those banks that are listed on stock exchange are "recommended" to disclose corporate governance information to the public.

Disclosure Practices

Generally, there is a good degree of transparency in the banks reviewed in this research and selected corporate governance-related information is accessible on the banks' websites. Nevertheless, it seems that not all banks provided online access to their constitutional documents. On the positive side, in one case selected internal corporate governance documents were also made available.
All reviewed banks disclose their management board composition (the degree of detail provided varied: for example, brief biographies were provided in only one case). The information on major shareholders and their ownership was disclosed in the banks' annual reports and in one case was also easily accessible online. All listed banks included a statement on the implementation of the Code of Corporate Governance

[16] "See "Study on Monitoring and Enforcement Practices in corporate Governance in the Member States", Appendix 1, Page 31.

[17] 2009 Annual report of the CNB, available at <http://www.hnb.hr/publikac/godisnje/2009/e-god-2009.pdf>.

developed by the Zagreb Stock Exchange in their 2009 annual reports and answers to the respective questionnaire. Only very few banks have independent directors on supervisory boards. The requirement to have at least one independent director on the supervisory board entered into force on 1 January 2010, and it is therefore expected that reporting on this issue will improve. In some cases, there was no information or only limited information available online with respect to agendas and decisions of (past) shareholder meetings. Although disclosures of significant events were available on the website of the stock exchange for all banks (being listed) only in one case were such disclosures also published on the website of the bank.

Former Yugoslavian Republic of Macedonia (FYROM)

The banking sector in FYROM comprises 18 banks and 10 savings houses. Fourteen banks are owned by foreign shareholders who hold approximately 90 per cent of the capital of these banks. The three largest banks hold around 80 per cent of the market in the country; two of them are owned by European banking groups and are listed on the exchange.

Legal Framework on Banking and Corporate Governance

The principal legislation on corporate governance is comprised in the Law on Trade Companies adopted in 2004 (as amended). The Banking Law, adopted in 2007 (as amended) regulates the establishment, operations and supervision of banks. The Corporate Governance Code for Companies Listed on the Macedonian Stock Exchange, adopted by the Macedonian Stock Exchange in 2006, requires listed companies to submit a report on compliance with the Code to the general meeting of shareholders for discussion as a separate item in the agenda.
The National Bank requires[18] banks to prepare and adhere to a corporate governance code, which encompasses rules for bank governance and for supervision over governance.

Bank's Management Structure

Banks in FYROM are governed under a two-tier system, where the general shareholders meeting appoint the supervisory board, and the latter appoints and removes the members of the management boards.

The banking sector in south-eastern Europe is more advanced than the securities markets.

The supervisory board is responsible for the oversight of the operations of the board of directors. At least one-fourth of bank's supervisory board's members must be independent, pursuant to the definition included in the Banking Law.[19] Banks are required to establish a risk management committee, whose members are appointed by the supervisory board from persons with special responsibilities in the bank.[20] One of the committee's members must be from the bank's management board. Banks are also required to establish an audit committee, to be appointed by the general meeting of shareholders. The majority of the committee's members must be from the supervisory board, while the others shouldbe independent. At least one of the members of the audit committee needs to be an auditor. All audit committee members need to have knowledge of accounting and auditing and be informed of the bank's operations, its products and services, the risks the bank is exposed to, the internal control systems and risk management policies of the bank.
The Corporate Governance Code further recommends listed companies to have a corporate secretary and to consider the introduction of nomination and remuneration committees at the supervisory board level.

Specific Disclosure Requirements

The 2007 "Decision on the Basic Principles of Corporate Governance in a Bank" requires banks to disclose data and information on their corporate governance on their websites and to prepare a corporate governance report – an integral part of the annual report on the bank operations – on an annual basis. The report must include – among others – information on composition and the functioning of the supervisory board and the board of directors and other bank bodies, the criteria for independence for the members of the supervisory board and the audit committee, the bank's shareholders structure, information related

[18] See Chapter III of the Decision on the Basic Principles of Corporate Governance in a Bank, issued on 27 December 27 2007

[19] See Article 2 of the Banking Law.

[20] According to Art. 2 (26) of the Banking Law, "person with special rights and responsibilities" is a natural person who is a member of the Supervisory Board, member of the Board of Directors, member of the Auditing Committee, member of the Risk Management Committee and other managers as defined by the Statute of the bank. In the case of a foreign bank branch, a person with special rights and responsibilities is a natural person managing the branch.

to the application of the bank's corporate governance code and information on the bank's conflict of interests prevention policy.

Disclosure Practices

According to a report published on the Macedonian Stock Exchange website,[21] four banks are listed on the Macedonian Stock Exchange. They all disclose the list of directors, but only two include their biographies or additional information on them. Only one discloses directors' professional expertise and educational background, while none specify their scope of responsibility. All disclose their corporate structure, but only two disclose their compliance with the Corporate Governance Code and their policy on shareholders rights.

Montenegro

There are 11 banks in Montenegro, six of which are listed on the Montenegro Stock Exchange. The three largest banks in the country are all subsidiaries of major international banking groups.

Legal Framework on Banking and Corporate Governance

Corporate governance regulation in Montenegro is essentially comprised in the Business Organisation Law enacted in February 2002. Banks operate according to the Banking Law, enacted in 2008. In May 2009, the Montenegro Stock Exchange adopted a voluntary corporate governance code. Listed companies willing to improve their corporate governance practices are requested to harmonise their practices with the code's recommendations and produce an annual corporate governance report explaining any departure from the code.

Bank's Management Structure

According to the Business Organisation Law, joint stock companies are organised under a one-tier system where the general shareholders meeting appoints the board of directors. The same structure can be found in the Banking Law for banks. The board of directors is responsible for the oversight of the bank's business activities. Bank boards are required to have at least two independent directors. Banks must have a CEO and at least another executive director appointed by the board. Bank boards are also required to appoint the members of the audit committee, made up of a majority of persons not connected with the bank, with experience in finance. Bank boards can create risk management, nomination or remuneration committees.

None of banks is listed on the Bulgarian Stock Exchange.

Specific Disclosure Requirements

The Banking Law requires banks to disclose exposure to risks in operations and the manner of managing those risks. There are no specific requirements to disclose corporate governance information to the public. The Corporate Governance Code recommends listed companies to adopt a written and publicly available reporting policy defining the rules and procedures of reporting to shareholders and the public. Further, the Code recommends that companies make use of their website for disclosure of information and that the annual report include a corporate governance report, prepared by the board, setting out the compliance status of the company with the requirements of corporate governance stated in the laws and the national Code.

Disclosure Practices

Currently only four companies have adopted the code, but no banks. When we looked at the websites in English of the largest banks in the country, we could not find any relevant information on their corporate governance.

Romania

There are 31 banks in Romania. The three largest banks in the country are owned by foreign investors. Only one of these is listed. As to concentration of bank assets, according to the National Bank of Romania, the top five banks held more than half of total bank assets.

Legal Framework on Banking and Corporate Governance

Credit institutions in Romania operate in compliance with the provisions of the Banking Act (Government Emergency Ordinance No. 99/2006 on Credit Institutions and Capital Adequacy, as amended) and Law No. 31/1990 on Commercial Companies, republished, as subsequently amended and supplemented). In 2008, the Bucharest Stock Exchange adopted a Corporate Governance Code to be applied by listed companies and banks under the so-called "comply or explain" mechanism. Starting from 2011, listed companies

[21] The Third Investor Relations and CSR Surveys of the web sites of the leading companies listed on the MSE was presented on April 26, 2010 and it is available at http://www.mse.org.mk/News.aspx?NewsId=4026

will be required to include a corporate governance compliance statement in their annual reports.

Bank's Management Structure

Credit institutions can be organized under a unitary or a dual board structure. According to the Law No. 31/1990, the board or, as appropriate, the supervisory board, can set up consultative board committees formed by at least two board members. In the case of unitary board structure, at least one member of the committees needs to be an independent non-executive director, while the audit and remuneration committees are to be composed exclusively of non-executive directors. In companies with a dual board structure, at least one member of each committee has to be an independent member of the supervisory board.
According to the Regulation No. 18/2009, banks can set up a risk management committee.

Specific Disclosure Requirements

According to the Romanian Banking Act, in order to ensure market discipline and transparency, credit institutions must disclose, at least annually, data and information regarding their activities, as soon as these are available. In general, the ways of disclosing such data and information remain at the credit institution's choice, but the National Bank of Romania may impose credit institution-specific measures regarding the content, frequency and ways of disclosure.

Disclosure Practices

With respect to the banks that we reviewed, their disclosure on corporate governance was limited. When documents referring to corporate governance were made available, they were not as comprehensive as might have been expected. Nevertheless, general corporate information (annual reports, financial statements, current shareholders and the composition of boards) was generally appropriately disclosed.

Serbia

There are 34 banks in Serbia and 19 are listed on Belgrade Stock Exchange. Among the five largest banks in the country, four are owned by foreign investors.

Legal Framework on Banking and Corporate Governance

Corporate governance in Serbia is mainly regulated by the Law on Business Companies, enacted in November 2004. A new bill, developed with the EBRD's assistance, is currently under discussion at the Government and should be submitted to the Parliament in 2011. Banks operate according the Law on Banks, enacted in 2005. In July 2008, the Belgrade Stock Exchange adopted the "Corporate Governance Code of the Belgrade Stock Exchange". Listed companies are required to observe the Code's recommendations or to explain the reasons for non-compliance.

Bank's Management Structure

The Law on Banks requires banks to have a board of directors and executive board. The board of directors is responsible for the oversight of the bank's activities. Directors are appointed and removed by the shareholders meeting. At least one-third of the members of the board of directors must be independent (i.e., persons not holding direct or indirect ownership in the bank or in the bank's holding). At least three members of the board of directors must have experience in the field of finance. The executive board is appointed and removed by the board of directors. Banks are also required to establish an audit committee, credit committee and committee for managing assets and liabilities. At least one member of the audit committee must be independent.

Specific Disclosure Requirements

The Law on Banks requires banks to publish the audited annual financial statement, the unaudited quarterly financial statements, the names of members of the board of directors and the executive board, persons holding participation in the bank or bank's holding company, along with the bank's organizational structure and the list of organizational units in the bank. The Law on Banks also requires the board of directors to provide an annual report to the general shareholders' meeting that includes information on salaries, fees and other earnings of the members of the board of directors and executive board of a bank and information on contracts between a bank and the members of these boards or other related persons.

Disclosure Practices

The reviewed banks' websites generally do not provide any dedicated specific corporate governance disclosure. Nevertheless, we found that general corporate information (annual reports, shareholders, members of the boards) was adequately disclosed. None of the websites of the 19 listed banks contains information regarding compliance with the Corporate Governance Code of the Belgrade Stock Exchange.

Conclusions

Following the analysis above, it is possible to draw some considerations.

The majority of banks in the region are subsidiaries of international banking groups. In terms of corporate governance this can pose specific challenges. Is it enough to transpose the parent company management structure in the subsidiary in order to comply with the best corporate governance practices? The legal framework in all countries carefully details the reporting requirements to the Central Bank, but often provides little guidance on corporate governance information that should be disclosed to the public. Arguably, because of the systemic importance of banks, especially in those jurisdictions where there is no stock market, banks should be subject to a higher level of transparency. Corporate governance codes require listed companies – and banks – to disclose their corporate governance structure under the so-called comply or explain mechanism, but the monitoring of such practices is weak in all countries in the region.

Further, the quality of information included in annual reports is very different among jurisdictions. In some cases the reports only provide a superficial description of the bank's business and assets portfolio, providing only little valuable information, often hidden in lengthy chapters or complicated financial statements. A simplification of the annual report's structure would be welcome.

The large majority of jurisdictions require banks to have independent directors in board committees. On the other hand, the definition of independence and the composition, role and functions of the committees vary. In some cases, board committees can include persons not sitting on the board, while there is no test for their independence.

Banks should have a clear understanding of the rationale behind the requirements of having independent directors and creating board committees. Further, their role, functions and responsibilities should be clearly disclosed in job descriptions for independent directors and by-laws for committees.[22] Above all, the recent crisis evidenced a crisis of knowledge and competence in the banking sector. There is much need for both a constructive dialogue on corporate governance with authorities and training of directors.

Once banks have fully understood the value of corporate governance, they will be in a position to influence governance of their corporate borrowers. Bad corporate governance is a risk: it is not difficult to understand that corporate borrowers with shady ownership and management structures and bad corporate governance practices may pose higher risk to investors. If this is agreed, then banks should consider having a good look at governance practices of their corporate borrowers in order to limit the risk of their investments. How this can be done? Banks could start requiring customers to present detailed corporate governance information and balance sheets prepared in line with good accounting standards as business pre-conditions. Central Banks should consider revising their credit classification regulations, connecting the performance of borrowers with qualitative criteria linked to corporate governance. All other things being equal, borrowers with better corporate governance should be able to obtain financing at a better rate. As a result, banks will be able to further limit the risks of their investments and companies will have a strong stimulus in order to improve their corporate governance practices.

A simplification of the annual report's structure would be welcome.

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[22] See also OECD Principle of Corporate Governance, VI, E, 2.

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The role of the regulator in bank corporate governance

*Matej Krumberger**

THE ROLE OF THE REGULATOR IN BANK CORPORATE GOVERNANCE
Corporate governance is one of key elements for safe and sound performance of credit institutions. During recent financial crises it has been demonstrated that aggressive risk taking polices contribute even further to financial instability. On the other hand, sound corporate governance has helped some institutions to manage the financial crisis significantly better than others. Prudent governance of credit institutions is primarily the responsibility of a bank's management; however, according to the new corporate governance principles, regulators are obliged to ensure that banks practice good corporate governance policies.

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If we start from the traditional definition (OECD) of corporate governance which refers to relations between a company's senior management, its board of directors, its shareholders and other stakeholders, such as employees and others, a regulator is without any doubt, beside governments, bond holders and depositors, one of the most important stakeholders. Supervisors have a keen interest in sound corporate governance as it is an essential element in the safe and sound functioning of banks.

I. Introduction

Although capital and liquidity are the immediate lines of defence for a bank, the governance of the bank ultimately determines the bank's strategy, business model, risk management and controls (Walker, 2009). Do banks have the right people in place, and do those people employ the right structures to assure that risks are properly managed and controlled is the permanent question of all supervisors. In spite of fact that Basel 2 already established possibility for the supervisory to control the bank's corporate governance, the recent financial crisis further revealed the limits of the existing supervision system.

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The existing rules and recommendations are based first and foremost on supervisory considerations and focus on the existence of adequate internal control, risk management, audit and compliance structures within financial institutions. However, they did not prevent excessive risk-taking by banks, as the recent financial crises demonstrated.
The aim of this paper is to describe existent corporate governance standards prescribed by international regulatory bodies (like OECD, Basel Committee on Banking Supervision, Financial Stability Board, European Commission and Committee of European Banking Supervisors) in the light of lessons that have been learned as a result of the crises. Purpose of the paper is to highlight the role of key corporate governance components such as role of boards of directors and senior management, effective implementation of corporate governance principles, risk management and internal controls, remuneration policies and the role regulators as well. Supervisors strongly believe that efficient corporate governance is in strong correlation with save and sound credit institution.

II. Basel Committee's Principles for enhancing corporate governance

The Basel Committee on Banking Supervision published initial guidance on corporate governance in 1999, with revised principles in 2006. This guidance assists banking supervisors and provides a reference point for promoting the adaption of sound corporate governance practice by banks. The principles also serve as a reference points for the banks' own corporate governance efforts.
There have been a number of corporate governance failures and lapses and many of them came to light during the recent financial crises. Therefore Basel Committee decided to revisit its 2006 principles and issued new principles for consultation in March 2010. The key areas in which improvements are necessary are:

- Board practices;
- Senior management;
- Risk management and internal controls;
- Compensation;
- Complex or opaque corporate structures;
- Disclosure and transparency.

Supervisors have a keen interest in sound corporate governance.

Board practices and senior management

The board has overall responsibility for the bank's business, risk strategy and financial soundness, as well as for how the bank organises and governs itself. When exercising those responsibilities, the board should also take into account the legitimate interests of shareholders, depositors and other relevant stakeholders. It should also ensure that the bank maintains an effective relationship with its supervisors.
The board should possess appropriate experience, competencies and personal qualities, including professionalism and personal integrity. The board need to possess adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue in order to enable effective governance and oversight. This experience or expertise includes finance, accounting, strategic planning, communications, governance, risk management, bank regulation, auditing and compliance. Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk appetite and policies approved by the bank's board. Senior management is responsible for delegating duties to the staff and should establish a management structure that promotes accountability.

Risk management and internal controls

Banks make money by taking risk, so managing risk is central to everything that a bank does, and the governance of risk is central to the control of the bank. The key rules applicable to risk management are that it should be independent from the executives taking the risk and should have sufficient authority, stature, independence, resources and access to the board. The risk management function is responsible fort identifying, measuring, monitoring, controlling and reporting on risk exposure.
Internal controls are designed, among other things, to ensure that each key risk has a process or other measure to control that risk and that such process or measure is being applied and works as intended. Internal controls help to provide comfort that financial and management information is reliable, timely and complete and that the bank is in compliance with various obligations, including applicable laws and regulations.

Compensation

Because of its contribution to risk-taking and bank performance, compensation is one of the key components

of corporate governance. Therefore the board is obliged to design and monitor and review the compensation system. It is important to know how different compensation practices can impact the firm's risk profile.
An employee's compensation should be effectively aligned with prudent risk taking. Employees can generate equivalent short-term revenues while taking on different amounts of risk. In longer term, a bank should ensure that variable compensation is adjusted to take into account all the risk an employee takes, including the risks that are difficult to measure (e.g. reputational risk).
Compensation payout schedules should be sensitive to the time horizon of risks. This could be achieved, when the compensation is deferred until risk outcomes have been realised. The compensations should be reduced or reversed if employees generate exposures that cause the bank to perform poorly in subsequent years. All 'golden parachute' arrangements under which terminated executives or staff receive large payouts irrespective of performance are generally not consistent with sound compensation practice.

Complex or opaque corporate structures and transparency

Banks create structures for legal, regulatory, fiscal or product-offering purposes in the form of units, branches, subsidiaries or other legal entities that can considerably increase the complexity of the organisation. The board and senior management should understand the structure and the organisation of the group (know your structure). This includes understanding the legal and operational risks and constrains of the various types of intergroup exposures and transactions and how they affect the group's funding, capital and risk profile. Another governance challenge arises when banks establish business or product line management structures that do not match the bank's legal entity structure.
Transparency is essential for sound and effective corporate governance. Disclosure should be accurate, clear and presented in an understandable manner and in such a way that shareholders, depositors, other relevant stakeholders and market participants can consult it easy.

Compensation payout schedules should be sensitive to the time horizon of risks.

Key messages of the revised principles

Among the most glaring corporate governance weaknesses identified during the crises, Basel views that shortcomings in the role of board and board practice have been the most prominent. The key issues under discussion were: qualifications of the board, including appropriate experience, competencies and personal qualities, training of board members, composition of the board, role of the chair of the board, and overall responsibility of the board of the parent company for adequate corporate governance across the group.
The financial crisis has also highlighted the importance of enhanced risk management. Since the crisis, the importance of the board to oversee risk management issues has increased substantially. Banks are increasing the number of board members with risk management background. The importance of independent senior executive responsible for risk management with sufficient stature has also increased.
In addition, risks should be identified and monitored on an ongoing firm-wide and individual entity basis.

Role of Supervisors

The board and senior management are primarily responsible and accountable for the governance and performance of the bank and shareholders should hold them accountable for this. However supervisor have also role in promoting sound governance. A key role of supervisors is to ensure that banks practice good corporate governance policies. Basel's principles require from supervisor that they should:

- provide guidance to banks on expectations for sound corporate governance;
- regularly perform comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles;
- supplement their regular evaluation of a bank's corporate governance policies and practices by monitoring a combination of internal reports and prudential reports, including reports from external auditors;
- require effective and timely remedial action by bank to address deficiencies in its corporate governance policies and practice;
- cooperate with other relevant supervisors in other jurisdictions regarding the supervision of corporate governance policies and practices.

III. CEBS approach to Corporate Governance

Committee of European Banking Supervisors (CEBS) has been heavily involved on Corporate Governance issues in recent years. CEBS focus its work on more narrow definition of corporate governance (internal governance) and excludes the outside components like shareholders, external stake holders or external auditors. Internal governance is a limited but crucial component of corporate governance, focusing on the internal structure and organisation of an institution. Internal governance for banks is codified in Article 22 of European banking directive 2006/48/EC (CRD), which requires '*that every credit institution has robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report risk it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures*'. Within the scope of Pillar 2, Directive also gives a power to supervisors to impose additional capital requirements in the case of non adequate internal governance of the institution. Due to very short definition in the directive and important impact within supervisory review framework under Pillar 2, which includes the internal capital adequacy assessment process (ICAAP) and reviewed by supervisors as part of their supervisory review and evaluation process (SREP), CEBS decided to elaborate more on internal governance standards. In this context CEBS published Guidelines on the Application of the Supervisory Review Process under Pillar 2 in January 2006 in which transpose BSCB principles into CEBS principles on internal governance, which helps both banks and supervisors. Later on CEBS published additional two guidelines that touch the area of internal governance High level Principles on Remuneration (April 2010) and High Level Principles on Risk Management (February 2010). At the moment CEBS works on consolidation, unification and up date of all three above mentioned guidelines into one Guidebook on Internal Governance, which CEBS plan to publish for consultation in October 2010.

CRD III stipulates provisions to strengthen rules on remuneration policies.

Guidebook on Internal Governance

In late 2009, CEBS performed survey on implementation of its internal governance principles published in January 2006. The survey clearly shows that banks needs to improve their internal governance procedures. One of the main weaknesses identified was that the institutions' complexity (riskiness of the products and services, different nature of local markets etc.) was not counterbalanced by appropriate internal governance arrangements. The corporate structure was not always transparent and organised in a way that promoted and demonstrated effective and prudent management. Another weak point was oversight by management body in its supervisory function, where management body failed to fulfil their supervisory duties. The management body in many cases did not understand the complexity of their business and excessive risk-taking policies. The risk management and internal control frameworks were often not sufficiently integrated within institutions or groups. A uniform methodology and terminology was missing, so that holistic view on all risks did not exist. Control functions often lacked appropriate standing, in terms of resources, status and expertise. On the other hand, sound internal governance practice helped some institutions to manage the financial crisis significantly better than others. These practices include mainly appropriate risk appetite and holistic risk management approach. Based on this survey and inputs from other international organisations CEBS is going to publish new Guidebook on Internal Governance that will consist of six main chapters:

- Corporate Structure and Organisation (know –your-structure principles);
- Management Body (principles on composition, appointment, succession and the qualification);
- Risk Management (risk appetite and tolerance, risk culture and models, new product approval);
- Internal Control (proper staffing, proper process for monitoring the set limits);
- System and continuity (information and communication systems and business continuity management);
- Transparency.

Internal governance includes all standards and principles concerned with setting an institution's objectives, strategies, and risk tolerance/appetite; how its business is organised; how responsibilities and authority are allocated; how reporting lines are set up and what information they convey; and how internal control is organised. Internal governance also encompasses sound IT systems, outsourcing arrangements and business continuity management.

IV. Recent changes in European banking directive (CRD III)

It has been seen during the financial crisis that excessive and imprudent risk-taking in the banking system threatens the financial soundness of credit institutions and causes systemic problems in the financial system. Among other reasons, inappropriate remuneration policies and practices at certain financial institutions have contributed to the aforementioned situation. In particular, excessive bonuses in the banking sector have induced efforts to achieve maximum short-term profits that have led to excessive risk-taking, resulting in the long-term instability of the banking system.

Therefore, the European Commission issued recommendations on remuneration policies in the financial services sector on 30 April 2009, while the Financial Stability Board issued principles for sound compensation practices, which were approved by the leaders of the G-20 countries in September 2009. The CEBS also issued recommendations on remuneration policies.

On these bases, a proposal for amending banking directive 2006/48/ES (hereinafter: the CRD III directive) was drafted, which also includes amendments linked to capital requirements for the trading book and re-securitisation. These amendments have not yet been adopted (CRD III has been adopted by European Parliament on 7 July 2010 and has been referred to the Council for adoption). It is however anticipated that amendments related to remuneration policies and practices must be transposed into national law by no later than 1 January 2011. CRD III stipulates provisions to strengthen rules on remuneration policies and practices for credit institutions and investments firms in order to minimise incentives for excessive risk taking. CRD III extends the scope of already mentioned article 22 of CRD with requirement ' .....*and remuneration policies and practices that are consistent with and promote sound and effective risk management*.' In addition, CRD III brings remuneration policies, like internal governance

The main purpose has been to correct and enhance weak corporate governance practices.

issue, within the scope of the SREP, so that supervisors have the possibility to limit variable remuneration or impose specific own funds requirements in case institutions do not meet the requirements with regard to remuneration policies and practices. The CRD III touches three main areas of internal governance: governance (annex V), risk alignment (annex V) and transparency (annex XII). The other most important amendments are as follows:

- A bank's supervisory board must appoint a remuneration committee, if a bank is deemed material for the banking system. This committee is responsible for drafting an independent opinion regarding the appropriateness of remuneration policies and practices, and with respect to financial and other incentives for the effective management of the bank's risks, capital and liquidity. It is responsible for drafting proposals for decisions regarding the issue of remuneration for discussion by the bank's supervisory board. In drafting these proposals, the committee must take into account the long-term interests of shareholders, investors and other entities associated with the bank;
- For the purpose of notifying the Committee of European Banking Supervisors, the national supervisor must collect information regarding the number of employees whose positions are categorised in a pay grade with remuneration of or exceeding EUR 1 million, including the main components of wages, bonuses, additional pension insurance and the associated business area;
- As part of its annual report or disclosures, a bank must publish on its website information regarding remuneration systems, which the national supervisor uses to compare remuneration systems within the banking system;
- Additional regulatory rules:
  - rules regarding remuneration policies and practices will be treated from qualitative and quantitative aspects of remuneration, such as:
    - remuneration policies must be in line with the business strategy, objectives and long-term interests of the bank,
    - the amount of the variable component of remuneration must be linked to an assessment of the personal performance of the individual, and the commercial success of his or her department and the bank as a whole,
    - the variable portion of remuneration may only be defined

in advance by contract in the case of new employees and only for their first year of employment,
    - the fixed and variable components of remuneration must be appropriately balanced, whereby the fixed component represents a higher proportion of total remuneration, and
    - 40% of the variable portion of remuneration must be deferred for at least three years for the purpose of facilitating the monitoring of the individual's performance in relation to the bank's operating results;
- A bank must take into account remuneration rules for work performed prior to the entry into force of the new regulation, but paid after the act's entry into force (transitional provision).
- CEBS is required to elaborate and issue guidelines on sound remuneration polices in the financial sector in order to facilitate the compliance of the remuneration principles included in the amended CRD.

CEBS guidelines on remuneration polices and practices

CEBS published its High Level Principles for Remuneration Policies with the intention to assist in remedying unsound remuneration policies in April 2010. Remuneration policies were not the direct cause of the crises; even so, they also contributed to its gravity and scale. It is generally recognised that excessive remuneration increased risk appetite that was disproportionate to the loss-absorption capacity of institutions and of the financial sector as a whole. Based on the CRD III requirements, the Committee of European Banking Supervisors (CEBS) prepared the Consulation Paper on Guidelines on Remuneration Policies and Practices in October 2010. The goal of the guidelines is "to ensure that their remuneration policies and practices are consistent with and promote sound and effective risk management" and "to deliver effective and meaningful implementation of [the CRD III] requirements to have remuneration policies and practices that are consistent with and promote sound and effective risk management", credit institutions and investment firms will have to observe the remuneration requirements on an institution-wide basis. The guidelines provide an angle for every principle-for both institutions and supervisors with the aim to facilitate the passage ofthe new risk-related philosophy on remuneration in the financial sector from theory into practice. During the process, however, a a level playing field must be preserved amongst institutions, "especially with a view to keeping claims on proportionality (both from supervisory and institutions) credible, effective and fair". The guidelines define all the remuneration forms of payments or benefits made directly by, or indirectly, but on behalf of, institutions within scope, in exchange for professional services rendered by staff. All remuneration can be divided into either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits depending on performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, cancellation of loans to staff members at dismissal, pension contributions) or non (directly) monetary benefits (such as health insurance, discounts, fringe benefits or special allowances for car, mobile phone, etc.). A »retention bonus« is a form of variable remuneration and can only be allowed to the extent that risk alignment requirements are properly applied. Institutions should ensure that variable remuneration is not paid through vehicles or that methods are employed which aim at artificially evading the requirements of the CRD III. Supervisors, in carrying out the Supervisory Review Process (SRP), should also devote adequate attention to this issue.

Transparency is essential for sound and effective corporate governance.

The main chapters of the guidelines are:
- Governance of remuneration (role of management body, remuneration committee, control functions);
- General requirements on risk alignment (basic principles, general prohibitions);
- Specific requirements on risk alignment (fixed versus variable remuneration, risk alignment of variable remuneration, award and payout process) and
- Disclosure.

V. Conclusions

In recent years, corporate governance issues have been receiving more and more attention from various international bodies (OECD, BCBS, FSB, EC, CEBS etc.). The main purpose has been to correct and enhance weak corporate governance practices as identified in the financial crises. A lot of principles of corporate governance were produced that will regulate this area in financial institutions in the future. Studies of corporate governance in last years shows us that the main weaknesses that significantly contribute to proper functioning of financial systems were aggressive risk-taking policies by management, quality and qualifications of board of directors and senior management and abnormal remuneration policies. It is clear that institutions should have developed risk culture and full understanding of the risks that they face. Beside risk management another crucial point is alignment of remuneration with risk profile. An institution's overall remuneration policy should be in line with its values, business strategy, risk tolerance and long term interest. Last of all, there will be also different role of regulators in the future, because they have to ensure that institutions practice good corporate governance policies. However, due to primarily responsibility of the institutions management for corporate governance, there will always be a question at which point the regulator should intervene.

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Bankers' pay and the financial crisis: policy debate and new regulation

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BANKERS' PAY AND THE FINANCIAL CRISIS: POLICY DEBATE AND NEW REGULATION
This paper reviews the economic policy debate on the issue how much the prevailing compensation practices in large international banks contributed to the financial instability and how this area should be regulated to prevent similar financial crisis in the future. We show that these issues have little to do with the prevailing banking business models and remuneration practices in Slovenia. Nevertheless, the implementation of CRD3 in January 2011, introducing new principles on rewarding bankers in the EU for long-term and risk-adjusted performance, could improve substantially the remuneration policies in Slovenia, especially in large state-controlled banks.

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The financial crisis has provided a lot of real life evidence for the public at large that the compensation programmes for bank executives and top professionals are not really tied to the long-term performance of banks. For example in the USA, Citigroup and Merrill Lynch together paid out nearly $9 billion in bonuses in 2008, while at the same time they lost $54 billion and then received government support from TARP totalling $55 billion. The explaination offered by the bankers to the American public was that employees have to be motivated to work hard in a turbulent time and that without bonuses the life would stop on Wall Street.

Introduction: banks' bonus culture, financial crisis and public outrage

In Slovenia, banking business models are very different and numbers are many times smaller but the pattern was the same. The CEO of the largest bank, completing his five-year term in 2009, cashed on accumulated success bonus at the time when the banking sector in the country was already receiving all kinds of government support to weather the crisis. General public across the globe could not believe that such bankers' payouts are possible in the middle of the financial and economic crisis.

In most international investment banks, compensation benefits gradually increased during the bull market years and represent 40% to 50% of revenues and approximately half of this amount was in the form of bonuses for performance.

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Not only bank executives, but top performing investment bankers as well, received most of the pay in the form of performance bonus paid partially in cash, but mostly in shares and stock options. The average bonus for the top investment banker on the Wall Street would be around $500,000, with the "stars" and executives receiving higher amounts and bigger portions in equity like instruments. Large payouts have become a part of investment banking culture and a source of unhealthy bonus competition among top firms for the "talents", needed for financial engineering that paved the way to financial crisis. When the recession started, the bonus culture and related business models were very slow to change, while in the short-term compensation stayed at bull-market levels even though the banks performance has deteriorated dramatically.
The widely publicised report of the NY State Attorney M. Coumo (2009) has described this "Heads I Win, Tails You Lose" bank bonus culture very clearly: "When the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well. And when the banks did very poorly, they were bailed out by taxpayers and their employees were still paid well." To make things even worse, as many bank executives were fired in the crisis, they received huge severance payments or they simply cashed in accumulated bonuses and pension benefits from the previous good years. The perception by the public was that they are rewarded for failure, while the rest has to suffer economic recession and pay for the global financial meltdown they have helped to create. Governments were called upon "to do something" about this. The first response came in the form of limitations on pay for firms receiving governmental financial support and in the form of additional taxes for high earners. The focus of these measures was on the level of pay and on the ethical issue: how much is too much during the economic crisis? Slovenia has followed this global trend, adding to the menu of pay restrictions specific recommendations, later replaced by the law, on the compensation in state owned firms, including the banks.
At the same time, the economic policy debate started on the issue how much the prevailing banking compensation practices contributed to the financial instability and how this area should be regulated to prevent similar crisis in the future. The outcome of this debate is going to affect the banks in Slovenia already in 2011, as the first part of the modified EU capital requirements directive (CRD3) is to be implemented. In what follows we present the economic rational of proposed changes in compensating bank managers and investment bankers. We wish to show that these issues have little to do with banking in Slovenia, but the new principles and standards will be applied worldwide anyway. Nevertheless, if the implementation takes into account our local conditions, new principles on rewarding only for long-term performance could only improve the remuneration in domestic banking sector.

Economic policy debate on bankers' compensation and financial stability

Economists focused the policy debate on how and when bankers are paid, and what are the implications for risk-taking in the financial sector. The main theoretical problem in the financial industry is that the real performance of individuals and firms can be determined only ex-post in the long run, after potential losses on these activities can be materialised. At least individual performance in other industries is much more straightforward to measure. Nowadays, there is a broad consensus among analysts and policy makers that the prevailing remuneration policies and the structure of compensation have provided top managers and top investment bankers with the perverse incentives:

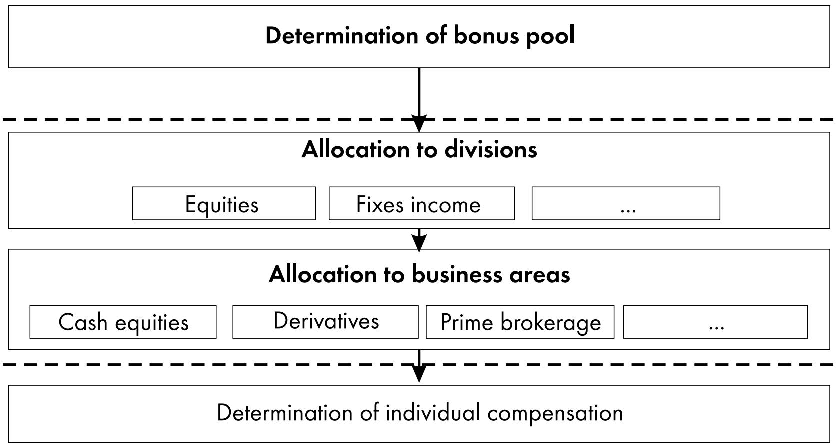
- to focus on short-term and not on long-term performance;
- to take more risk than optimal for the bank;
- to use excessive leverage, increasing the bankruptcy risk above optimal for the bank;

It is important to understand that these problems are not limited only to top managers, due to the traditional bonus culture in investment banking they are deeply rooted in the business models of the big international institutions.

Compensation of top employees in investment banking

The typical compensation process in large global institutions is the following: on the basis of the current performance of investment banks bonus pools are determined and allocated to different parts of the institution, down to top performing individuals who are internally competing for the share of the pie (see Figure 1). In this system, where individuals are paid bonuses only on the basis of current profits, they have a strong motive to maximise short term results by bringing additional risk to the firm and by reporting to senior managers that everything is well were in fact it is not. As Rajan (2008) points out this leads to pervasive and systemic "fake alpha" in the industry if the rewards have no claw back provisions for the case of future losses (alpha being returns above average on the market).

Figure 1: Stylised compensation process



Source: Institute of International Finance & Oliver Wyman 2010 Compensation Survey

Figure 2: Historical overview of excessive wages in the financial sector

Source: Phillippon (2009)

To understand this point note that financial firms committed to the originate-to-distribute model of banking in the 2007-2008 crisis were exposed to almost 50% of AAA-rated CDOs of non-prime mortgages. This is surprising as the whole idea of securitization and transaction oriented banking was to transfer credit risk from banks to other capital markets investors. The explanation is rather simple but horrifying: these investments were treated by the firms as essentially riskless and traders could book high premiums as current profits of the business, leading to big bonuses with the incentive to buy them even more (NYU Stern, 2009). Such aggressive bonus-based remuneration system for individuals is also difficult to monitor as desperate traders by violating the rules can inflict colossal damage to financial firms.

T. Phillipon (2009) analysed empirically relative wages in the US financial sector over the past century and found that bankers, after controlling for high skills, were still paid about 30% to 50% too much before the crisis. Studying wage distribution in the UK between 1998 and 2008, Bell and Reenen (2010) report that top 10% gained an extra three-percentage point of the national wage bill and three quarters of these gains went to bankers as a result of bonuses. This increased share of the pie for bankers amounted to an extra £12 billion per year by 2008.

The key factors in driving up relative wages and attracting high-skill employees in the financial sectors are deregulation, financial innovation and active corporate finance activity. Striking similarity exits between the pre-crisis situation at the time of Great Depression and the current crisis: banking was high skill/high wage industry and on the top of that, bankers were overpaid on the high-skill market. During the 1930s, the financial sector lost its high human capital and wage premiums disappeared due to new regulation, slow economic activity and reduced profitability in banking. (Phillipon, 2009)

There are many reasons to believe the same will happen after this crisis as economic activity will recover only slowly and the new regulation will be implemented in banking. The labour market is currently full of high-skilled bankers looking for any job and the interest of MBA students to study innovative high-tech finance has already decreased. Incentives were very different before the crisis: those Harvard graduates that worked in the financial sector earned almost 3 times more (195%) than others after controlling for grades, year of graduation and other factors (Duflo, 2008). The high-skill labour markets actually work but with some delays. It has been reported that cash bonuses and long-term incentives in the global industry were reduced for about 20% in 2008 (Economist, May 28th, 2009) and for about 20% in 2009. (IIF Report, 2010). Nevertheless, it should not be overlooked that the core of the problem is not only the size of bonuses but more the way in which are they determined and what are the implications for risk-taking.

The analysts agree that the most effective and simple solution for excessive risk taking at the individual level is to introduce claw back provisions or defer payouts. One way to fix the problem is to introduce bonus-malus approach, where good performances add and bad performance subtract from the multi-year bonus pool of the individual banker. The alternative solution is to use ex-ante risk-adjusted performance indicators instead of current profits. This is easy to declare as a standard, but very difficult to implement in practice where individual performance at one trading desk has to be adjusted for risk-taking.

For example, Jašovič (2009) presented the multi-year compensation model using economic value added (EVA) of the firm as performance indicator. EVA is very sound economic concept as it takes into account cost of capital and overall risk of the bank for shareholders and creditors. It is well known in management that EVA concept can be applied to business units as well. Should we go further in the banking, all the way down to the individual level? Banks, being into risk management business, are expected to do much more than apply the same cost of capital across all activities. All different types of risks associated with one business activity are to be identified: liquidity, credit, market, operation, compliance... Many of the activities might show no profit once adjusted for the risks undertaken. This should put an end to the unjust bonuses and stop same extravagant practices in investment banking. The "innovative financing" in banking is expected to be reduced, not only due to new regulation and prohibitions, but for business reasons as well: it makes no money in the long run when proper adjustments are made for risks undertaken. The remuneration system in investment banking is expected to become closely related to risk management in the bank.

The problem of excessive risk taking by top managers and top employees are somewhat different. Individual investment bankers, as opposed to bank executives, have very limited direct impact on the overall performance of the bank. Therefore, Bell and Reenen (2010) see little reason that following the crisis increasing portion of bonus is given to top employees in terms of equity. To align the interests of these employees with the interests of shareholders has little sense if they cannot influence the overall performance. In fact, equity bonuses with a few years of vesting period were typically used to make it more expensive for these top employees to leave the firm. To postpone the payment of bonuses in cash or in equity to wait for the final results of the specific activities of these employees is a very different concept.

The big task for the industry is to fix compensation for individual investment bankers, not only top executives. This will not be easy to accomplish as the long-lasting business models have to be changed and this can happen in the global investment banking industry only gradually. For Slovenia, with limited investment banking activity and practically no excessive investment banking bonuses for top performers, this is not a real issue. Therefore, we can focus our attention to much more straightforward problem: how to fix remuneration policies for bank executives who have by definition a direct impact on the overall bank performance and risk-taking. This has been widely debated academic and practical issue for many years.

Compensation of executives in banking

The standard economic argument, mostly contributed to the writings of M. Jensen (1990), is that managers will work in the best interest of shareholders when their compensation is linked to the change in shareholders` value. The most direct link to solve this agency problem between executives and shareholders is to pay executives as if they were shareholders themselves (Murphy, 1999). Following this basic logic bank executives around the world (as opposed to Slovenia) are typically paid fixed salary, representing only a small portion of the overall compensation, and several times bigger performance related bonus, paid mostly in terms of shares and share options as the long term incentives (Figure 3).

With this structure in place, annual increase in wealth of executives is not so much related to annual pay but much more to the rising price of the shares of the firm. The implicit assumption in this model is that capital markets are efficient in perceiving risks and in valuing the equity of the financial firms. In addition, efficient capital markets are forward looking and cannot be misled by opportunistic short-term actions of bank executives. In simple words: under these assumptions movement of the share price is very good proxy for the long-term performance of the firm.

The collapse of the capital markets of epic proportions in 2007-2008 was an excellent opportunity for economists to explore further some of these implicit assumptions for all listed firms, but for rescued financial firms even more so.

The second more important issue in the remuneration of bank executives is related to the moral hazard that

Figure 3: Rewarding: the median mix of compensation for the highest-paid executives, 2008

Source: Hewitt associates retrieved from: (The Economist, 2009)

arises from the fact that banks are important for functioning of the whole economy and therefore they enjoy explicit and implicit guarantees by the government. Bank shareholders might have financial interest in more risk-taking than it is socially desirable. They might induce executives to excessive risk-taking, as part of the costs is at the end of the day covered by taxpayers. This moral hazard argument is the basis for much of the traditional regulation with respect to risk-taking in the banking industry.
The wide agreement is that after this crisis the remuneration policy in banking should become additional regulatory issue to protect soundness and safety of the financial system.
The moral hazard issue in the financial industry has been in the focus since we learnt in this crisis that many non-depositary financial institutions have become too big or too important to fail as well. The only solution for the "too big to fail problem" is that such institutions should not exist in the first place, but nobody has really the power or the will to do so. Additional regulation will be used, as a second best solution, with the objective to better monitor factors that might lead to excessive risk-taking in the financial industry. Remuneration principles and practices have been identified as one of important factors contributing to this financial crisis and the new world-wide regulatory rules for banks have been drafted after an intensive and interesting debate.

Academic proposals to fix executives' pay in banking

The suggestion by the corporate governance experts after the crisis was that the remuneration in all large firms should become much more transparent and that the shareholders should have the right to say on the remuneration policy. Public disclosure of the structure of compensation for individual executives and board members, pre-approval of compensation for supervisory boards by shareholders and regular discussion on compensation policy on shareholders` meetings were all proposed and introduced globally to fix this internal corporate governance problem. Note that the implicit assumption of these "the right to see and say" proposals is that the prevailing compensation practices, mostly the high level of payouts, were not aligned with the interest of shareholders. At the same time, these proposals are not solving the moral hazard problem in financial industry: executives and shareholders might have a strong common interest to play "we win, you lose" game with taxpayers. The structure, not the size of payouts is the real problem for financial stability.
Other analysts argue that the system of compensation in the crisis actually worked as many of the top executives in collapsed financial institutions have lost fortunes along with shareholders and taxpayers. In this sense the internal corporate governance was the way it should be and managers were sharing the destiny of shareholders. When the bank fails, it often looks like executives are being paid for failure, when in fact they are liquidating shares that were awarded to them many years ago at much higher prices.
Therefore, the real issue might be that capital markets, especially before the crisis, had difficulties with proper valuing of the equity of financial firms and with the risk assessment of these firms (NYU Stern, 2009). Did the executives with inside information know better and exploit the mispricing on the market? Fahlenbrach and Stults (2010) have made an empirical study including top banks and they report that bank executives did not reduce their holdings of shares in anticipation of crisis or during the crisis. They found for the median bank CEO that the value of the shares and share options was eight times the value of his annual

compensation. Consequently, they suffered extremely large losses in the wake of the crisis. The large amount of unexercised options is striking and the typical bank CEO was not expecting the market crash.

It is comforting to hear that capital market mispricing of the financial firms in the last decade were not exploited on a large scale by executives receiving share-based compensation but should we keep this system in the future? Definitely not say those who believe that capital markets are proven to be short-sighted, volatile and driven mostly by speculation, not by actual company results.

Martin (2010) argues that we should scrap stock-based compensation all together and go back to principles: compensation should provide executives with an incentive to reach real life results of the firm like earnings per share (EPS), return on invested capital (ROIC) and market share, which are all directly influenced by executives` activities while the share price is not. As a share price is nothing but a market consensus about the expected future performance of the firm, executives are trying hard to raise these expectations at least temporary and get out of the market before expectations fall. Similar "back-to-principles" argument is that executives' compensation should be linked directly to the strategy of the firm and its implementation. These "reforming" proposals are very familiar to most of as still living in the world of non-listed firms and illiquid capital markets.

Many proposals were made to adjust better the existing share-based compensation model to the real life functioning of capital markets. The financial industry is pro-cyclical and it has been experiencing very dynamic growth in the years before the crisis. Financial innovation was on the rise and profits exploded in all parts of the financial sector. Executive pay in banks merely followed the overall optimistic trends and profitability in the financial industry in the last decade. Rappaport (1999) suggested that firms should index their shares to peer firms or the larger markets when determining performance metric (benchmarking) to avoid situations where executives make a windfall gain simply because of being in the growing market, regardless of their relative performance.

Bebchuk and Fried (2009) argue that to tie better equity compensation to long-term shareholders value details are important to solve the problems of quick liquidation of allocated shares and timing of the stock market by executives. They propose to clearly separate the date of allocation of bonuses from vesting and cash-out dates. Executives should be required to hold vested shares for very long periods, even if they leave the firm or retire, as this would tie their payoffs to long-term shareholder value. Executives should be granted bonus shares on pre-specified dates, while the liquidation of shares should be publicly disclosed and executed gradually and automatically on the market in the pre-specified periods. These arrangements should take care of price manipulations, market timing and trading on inside information by executives.

> *Large payouts have become a part of investment banking culture.*

The asymmetric incentives of executive bonuses whereby they are paid well in good times but they are not really penalised in bad times have been under intense scrutiny after the crises. Stock options held by executives, as the important part of the compensation, are actually a bet on the future of the firm. If things go well they get rich and if things do not go well nothing much happen. Downside risk is missing in this arrangement. There are various proposals to fix this asymmetry.

Management guru H. Simon argues that after this crisis each appointed executive should be legally required at the start to buy from his own pockets shares of the firm in the amount of at least two annual salaries. G. Bennett Stewart (1991) proposed a similar idea twenty years ago with a leveraged equity purchase plan (LEPP) for managers. The firm would give at the start a loan to managers for buying shares of the firm. If things went bad, the value of the shares would fall and the loan would be repaid from the managers` own pockets. In this way a limited personal liability of the managers for bad performance is introduced in compensation.

For bank executives N. Record (2010) proposed that bankers would remain personal liable for the cumulative amount of bonuses they receive for a long period, perhaps 10 years. Their liability would be triggered only if the equity of the bank is wiped out by losses and the bank is to be liquidated or rescued. In fact, their liability would represent the contingent equity of the bank, being placed between equity and debts of the bank. This proposal is actual taking us back to the past: for 200 years investment banks were operated us unlimited partnerships. The flotation of Goldman Sachs in 1999 ended this ownership model and, from today's prospective, the era of conservative banking as well.

Bankers' liability can be introduced also by creating special type of the equity for employees (E-shares) as proposed by Leijonhufvud (2010). If the bank were to fail, these non-transferable E-shares would make holders liable for a sum equal to value of shares on the day of allocation. Simply, in the case of a disaster they would have to pay in the difference between the original and current value of shares. These shares would be exchangeable one-for-one for ordinary shares at market value five years after living the bank. Only employees paid above the basic level would be included in the program, with the proportion of compensation in E- shares rising through the ranks up to 80% at the CEO level in order to link decision makers' liability to their risk taking. The author believe that this additional personal liability would change the attitude towards risk of the entire organization as everybody would be hurt by excessive risk taking in one division.

All claw back provisions structured as personal liabilities of executives might look very justified after this crisis but they open many complex details that are not easy to resolve in the today modern world. What is the tax treatment of conditional payouts? How to prevent executives from hiding their financial assets to avoid paying for their liabilities? Should they be allowed to insure this personal liability? Once the rewards are allocated, vested and paid out it becomes where difficult to claw them back.

After governments rescued hundreds of banks across the globe, many new proposals were made how executive pay in financial firms should be aligned not only with the interest of shareholders but with the interest of creditors as well. If the firm goes bankrupt, executives are penalised by losing the entire equity-tied bonus - regardless of whether creditors recover 80% or 10% of their claims. When the firm is close to bankruptcy and equity is close to zero, things cannot get much worse for executives and shareholders. They might jointly gamble even more trying to salvage the firm. On the other hand, when executives are paid in bonds or their compensation is deferred, the motivation of executives in bankruptcy is dramatically changed as they have to stay in line with other unsecured creditors (Edmans and Liu, 2010).

Shares and stock options based compensation, coupled with high leverage in banking, provides executives with risky bet on the value of banks' assets. They share the fortune with shareholders but they are isolated from large losses they might impose on creditors and the government as a guarantor of deposits. Bebchuk and Spamman (2009) propose that regulators should require that bank executives are paid not only according to equity value but to debt value of the firm as well in order to prevent excessive risk-taking and future financial crisis. This can be done directly by paying executives in bonds and indirectly by linking bonuses to the price of debt or credit default spreads or credit rating of the firm. The balance between equity and debt part should be adjusted to the risk appetite of the firm. For example, after being rescued by USA government AIG recently announced new executive compensation plan with 80% of bonuses depending on price of debt and only the remaining 20% on price of shares.

Individuals are paid bonuses only on the basis of current profits.

Banks where executives' bonuses are tied to accounting measure should also change performance metric to account for the risks assumed by creditors as well. In the past, measures like return on equity (ROE) or earnings per share (EPS) were used that are linking interest of executives with interest of shareholders. Broader accounting measures like earnings before any interest paid to bondholders or analytical measures like economic value added (EVA) should be used to cover the interest of both: shareholders and creditors.

We believe that indirect claw back solutions through bonus-malus approach can accommodate most of the concerns in a debate on executives' compensation and risk-taking in banking. What is important to incorporate in this model is downside risk for bad performance at all times. This requires simply that the bonus pool of each executive that is potentially at risk is always maintained above the prescribed minimum level. This is his personal exposure to the bank if things go wrong. Newcomers have to pay initially in the bonus pool to get the job and bad performers have to maintain the minimal level in the bonus pool with additional payments or leave the firm. What happens if the bank is liquidated or rescued? Bonus pool is treated as contingent capital and provides additional protection to creditors of the bank. The basic model (Jašovič, 2009) is very flexible: the payout date can be deferred for many years to reward long-term performance, roll over system of bonuses can smooth the payouts over the cycle, metrics for performance can be risk-adjusted (for example EVA) or linked to the bank strategy or annual projects, payouts can be in cash only and, important for Slovenia, there is no immediate need for the bank shares and bonds to be listed.

Figure 4: Summary of FSB/G20 implementation standards, September 2009

	Key FSB principles	Implementation standards (released Sep 2009)
Compensation governance	▪ Active Board involvement ▪ Involvement of the Risk function ▪ Independence of control functions ▪ Disclosure requirements	▪ Remuneration Committee should involve majority non executives and work closely with the Risk Committee ▪ Remuneration for control staff should be adequate and independent ▪ Remuneration Committee should submit an "externally commissioned compensation review to the regulators and public annually" ▪ Detailed description of compensation framework (incl. indicators used for performance measurements and risk adjustments) and quantitative impact of current and deferred compensation required
Bonus pool calculation and funding	▪ Risk adjustment of compensation ▪ Link to Group performance ▪ Implications for capital position	▪ Risk adjustments should reflect the cost and quantity of capital consumption as well as the liquidity risk ▪ A firm's financial performance should be reflected in bonus pool sizing ▪ Capital build up to take priority over compensation payouts – regulators to limit bonus payouts when it hinders build out of a sound capital base
Determination of individual compensation	▪ Risk adjustments in bonus allocation ▪ Accountability in performance measurement	▪ No further guidance released in Sep 2009; previous guidance includes – Thorough measurement and stress testing of risk positions – Effective approach to capital allocation for the risk exposure – Reliance on expert judgement to sufficiently incorporate opaque risks
Payout structures	▪ Link to BU/individual performance ▪ Sensitivity of payouts to future performance ▪ Use of non-cash instruments ▪ No use of multi-year guaranteed bonuses	▪ Specific guidelines introduced to level the playing field globally – Mandatory use of payout conditions (e.g. malus/clawbacks) – 40-60% of bonus should be deferred; >60% for the senior most management (% should increase with level of pay/seniority) – At least 3 years deferred; higher for businesses with higher risk holding period – >50% of bonus to be awarded in non-cash instruments; stock based instruments should be subject to an appropriate vesting policy

Source: (Institute of International Finance & O. Wyman, 2010)

New world-wide rules on bankers' remuneration

In parallel with lively academic debate on bankers` pay new regulation in this field has gradually emerged, as a part of comprehensive financial reforms, coordinated on the global level by the leaders of G20 and regulators participating in the Financial Stability Board (FSB). They issued principles for sound compensation practices (April 2009), later complemented by implementation standards presented in the Figure 4. It was recognised that compensation at large financial institutions are one factor among many that contributed to the financial crisis. Almost 80% of the market participants from big international institutions share this view. Large bonuses based on short term profits without adequate regards to the long-term risks left firms with limited resources to absorb the loss in the downturn. It was recognised that reforms can be effective only if they are applied consistently on the global level.

Figure 4: Summary of FSB/G20 implementation standards, September 2009
Source: (Institute of International Finance & O. Wyman, 2010)

New rules for bankers' remuneration in EU

In response to the financial crisis the Larosière Group was set up in EU to propose recommendations for reforming the European financial supervision and regulation. With regard to remuneration structures they recommend that compensation incentives should be better aligned with shareholder interests and long-term profitability by basing the structure of financial sector compensation schemes on the principles that bonuses should reflect actual performance, should not be guaranteed, and that the assessment of bonuses should be set in a multi-year framework, spreading bonus payments over the cycle. This was in full accordance with FSB Principles.

To address the problem EU Commission in April 2009 issued two recommendations regarding remuneration: one for listed firms and one for financial institutions. At the same time CEBS issued accompanying High Level Principles for Remuneration Policies. As a final step It was announced that Capital Requirement Directive will be modified (CRD3) to incorporate the remuneration issues under prudential oversight of banks and financial firms in EU.

The explanatory memorandum of CRD3 is stating that the objectives of the directive with respect to remuneration in the EU financial sector are:

- to ensure that remuneration policies and practices are consistent with effective risk management and follow high-level principles on

sound remuneration;
- to ensure that supervisors are able to require the firm to change remuneration structure (qualitative measures) or to provide for additional capital (quantitative measures);
- to ensure that supervisors may impose financial or non-financial penalties;

The scope of the directive is the total remuneration, including pension benefits, for staff whose professional activities have a material impact on the risk profile of credit institutions and investment firms in EU. In addition to senior managers, the directive applies to all important risk takers, control staff and the rest of high paid employees.

Both types of institutions – credit institutions and investment firms - are included to provide level playing field on the labour market. At the same time firms have flexibility to apply the high-level principles on sound remuneration in a way that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities (so called proportionality principle should apply especially to investment firms).

The assessment of the performance is set in the multi-year framework of three to five years and payouts of the variable component are spread over a long period to take into account risks related to the business cycle.

Performance related remuneration for individuals is based on a combination of his individual performance, where financial and non-financial criteria are used, and the performance of his business unit. The use of automatic formulas without judgment is not allowed.

Measurement of performance for variable remuneration and internal allocation of bonuses within the institution should take into account all types of current and potential future risks, including cost of capital and liquidity required.

The severance pay is required to be related to the performance over time and it is designed in a way not to reward failure.

Firms should set appropriate balance between fixed and variable remuneration and the fixed part should be sufficient to operate fully flexible remuneration policy. The original proposal to limit the variable pay to 100% of the fixed pay was successfully lobbied away by the financial industry. Nevertheless, the general requirement to cap the variable pay in relation to the fixed pay was imposed. There are additional limits on variable remuneration for troubled and undercapitalised institutions and ex-ante guaranteed variable remuneration is allowed only for the new staff in the first year.

The "innovative financing" in banking is expected to be reduced.

The directive is very detailed with respect to structure of pay and deferred payouts of the variable remuneration:
- at least 50% of any variable remuneration shall be in non-cash form, consisting of an appropriate balance of equity and credit linked instruments. These instruments should be subject of long retention periods ;
- pension benefits as well, should be in the form of equity and credit linked instruments with 5 years retention period
- the staff is not allowed to hedge or insure the personal risk related to remuneration arrangements;
- at least 40% (for high amounts at least 60%) of variable remuneration is to be deferred for three to five years;
- the variable remuneration is conditional, it is paid and vests only if it is sustainable for the institution and it does not limit its ability to strengthen the capital base;

The more detailed CEBS guidelines on sound remuneration policies, to be issued shortly, should provide further guidance for firms and regulators. The draft guidelines (CEBS, 2010) are very restrictive in the interpretation of CRD3: the retention period for 50% of variable pay in securities should apply equally to deferred and non-deferred portion of variable pay. This means that for the highest earning individuals at most 20% of bonus can be paid upfront in cash and 20% upfront in securities, to be held for the retention period and to be subject of implicit ex-post risk adjustments. The rest should be deferred and subject to explicit ex-post risk adjustments. If (when) this 60% is allocated, it should be at least one half in securities with the additional retention period post-vesting.

In terms of internal corporate governance for sound remuneration, the independent and competent Remuneration Committee is required to play the key role in setting the remuneration for executives and adopting and periodically reviewing the remuneration policy. The implementation of the remuneration policy is to be subject of regular internal compliance reviews. Staff members in control functions should have proper authority and they are paid independent of the performance of the business units they oversee. The Remuneration Committee should directly oversee the remuneration of senior staff in the risk management

and compliance functions.
The CRD3 obligations related to remuneration policy will start to apply in January 2011. They are to be used for all current payments based on the contracts signed before the effective date, including the remuneration awarded and not yet paid for the services provided in 2010. This retroactive application was justified with a high degree of financial instability in the EU and with the need to avoid discriminatory time effect of its application across the industry.

Conclusions: bankers' pay in Slovenia and the financial crisis

The banking sector in Slovenia has been deeply affected by the financial and economic crisis. After the introduction of the euro, domestic banks became heavily dependent on the wholesale financing from abroad. The initial shock from the global financial crisis was brought to domestic economy, as banks, due to the freeze of international credit market, were not able to refinance credit lines from abroad. Next, the severe economic recession in the small, export-oriented Slovenian economy has led to strong deterioration of banks` loan portfolios. Most of the banks` losses are linked to financing of over-sized construction and real estate sectors and to financing of speculative and highly leveraged domestic ownership consolidation. Government had no choice but to support banks when the financial crisis exploded abroad and the overall economic situation worsened at home. Assistance was provided in various forms: a general guarantee on household deposits, placements of large amounts of funds borrowed by the government internationally into banking deposits, recapitalisation of one bank, guarantees for lending to domestic firms and households, and guarantees on new bonds issued by banks in foreign market. In general terms, the pattern in Slovenia was the same as at the global level: when times are good, banks and bankers do very well, when times are very bad, taxpayer support is needed.
Could the remuneration of bankers in Slovenia be an important and systemic contributing factor for the domestic lending extravaganza and for ignoring liquidity risks of short-term wholesale financing from abroad?

Over-restrictive remuneration laws should stop to apply to state-owned Slovenian banks.

The bankers` bonus culture was not widespread in Slovenia as the investment banking is not well developed. Performance bonuses for top employees were rather small relative to fix pay (at most up to 40% of the fixed pay) and only a few bank executives received bonuses representing more than 100% of the fixed pay. According to Polanič report (2010) the largest bonus of the banker in Slovenia in 2009 was about 85% of the fixed pay. Bonuses were mostly paid in cash, not in shares or share options, as only two banks are listed on the stock exchange. In comparison with the practices in large international institutions, the structure of bankers` remuneration in Slovenia was rather conservative and with limited direct incentives for excessive risk-taking.
At the same time, bankers' remuneration in Slovenia was not aligned with the long-term banks' performance as it was mostly based on accounting profits and paid in cash with no deferrals. With the economic slowdown, credit risk on loans given at the time of prosperity materialised and the previously profitable banks are now reporting huge impairments with no ex-post consequence for the executives responsible for approving these loans.
The best known example is the remuneration system in NLB, the largest bank in the country controlled by the state and foreign strategic investor. The bank was making solid accounting profits before the crisis, rewarding executives and members of supervisory board on the basis of this accounting performance and paying out regularly 40% of profits as dividends to shareholders. At the time, everybody seemed to be pleased with the arrangement. When the CEO of the bank completed his term in the middle of the crisis and left the troubled bank with accumulated bonus for five years in cash, the general public was astonished by the number. It has been later reported that the annual bonus for all executives in the period 2002-2008 was paid on the basis of realised earnings per share (EPS) above the target EPS which has not been adjusted for improved performance of the bank or the whole banking sector in Slovenia since 2002! Even with the switch from domestic accounting standards to IFRS in 2006, when EPS automatically increased across the entire banking sector of Slovenia, there was no real attempt by the supervisory board to prevent executives of the bank benefiting from this "fake performance". The main characteristics of this bonus system are in direct conflict with the proposed new rules: based on accounting profits, based on short-term one year performance, no benchmarking on the industry, no adjustment for the business cycle, no

cap on variable pay, no claw backs or malus provisions, no deferred payments, all paid in cash and nothing in securities with the retention period, automatic formula used with no additional judgment by the supervisory board.

In 2009, Slovenian parliament passed temporary tax law (named Kramar act after the CEO of the bank) imposing a 91% marginal tax rate for high salaries, bonuses, severance payments for managers and incomes of supervisory board members in state supported firms, including banks. In addition, government recommendations and later the law (named Lahovnik act after the sponsoring minister) limiting salaries, bonuses and severance pay in state-owned firms were passed which applies to state-owned banks as well. Politicians over-reacted with these laws limiting the size of the payouts in banking to please the general public. The state-owned banks are at present paying executives about 30% smaller fixed pay than before the crisis. Bonuses are limited to 30% of fixed pay and the overall pay in large state-owned banks is about 40% less than the pay in smaller private and foreign-owned banks (see the data in Polanič(2010)). The supervisory board members in these banks are paid only for the time spent at meetings. These remuneration arrangements are not sustainable in the long run and they have introduced a new systemic risk due to the fact that state-owned banks still represent the most important part of the banking sector in Slovenia.

It is hoped that with the implementation of CRD3 in January 2011 in Slovenia these over-restrictive remuneration laws would not apply to state-owned banks anymore. This would give them opportunity, contrary to the worldwide trends in banking, to increase the total level of pay as well as the size of variable pay in order to be competitive in attracting and motivating top managers. The issues of long-term performance adjusted for risk should be addressed on top of that in all the banks operating in Slovenia, using the appropriate metrics, bonus–malus approach and deferred payouts for bonuses as required by CRD3 and presented in this paper.

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Market supervision of bank operations

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MARKET SUPERVISION OF BANK OPERATIONS
In the wake of the latest financial and economic crisis, numerous studies have offered more or less plausible solutions to exit the current crisis and avoid its recurrence. Market discipline has plenty of untapped potential in corporate control of banks (corporate governance). The idea given in relation to mandatory subordinated debt issue and the possible replacement of the capital requirements from Pillar 1 with market discipline has been side-tracked by adopting regulatory modifications under Basel III, which have enhanced capital requirements from the so-called Pillar 1 even further.

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One of the characteristics of financial institutions is that private (corporate) and public (regulatory) supervision are intertwined. Corporate supervision, broadly construed, is control conducted by investors (shareholders and creditors) that provide funding for financial institutions to run the business of financial institutions. In order to ensure the highest possible yield on their investment, they reach out for devices for controlling (governing) the institution in which they have invested their money.

1. Corporate and regulatory supervision

Shareholders may exercise internal oversight through the bodies of corporate governance (supervisory boards or boards of directors) and may exercise their vested interests through these bodies and align such interests with the corporation's vested interests. They may also control the institution (corporation) by deploying external, market monitoring mechanisms – by purchasing or selling shares and other equity holdings in enterprises. External or market supervision/monitoring may also be effective since, for example, shareholders in such a case do not remain inactive and "vote with their feet", but they buy shares issued by sound enterprises (buy-in) and dispose of the shares of ailing enterprises (exit). Market prices of equities are formed in relation to investor behaviour and share prices reflect what investor expectations are with regard to return on equities.

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Enterprises are not financed only by means of raising equity capital. This applies in particular to the financial institutions, which are largely funded by borrowing (taking loans and issuing debt instruments). The investors in debt financial forms also control (monitor) debt issuers – an enterprise or a financial institution. Control (oversight) may be indirect (external supervision or market monitoring), where the market interest rate expected to be paid to creditors reflect the risk inherent in the debtor. It may also be direct when the creditor demands that the debtor – the issuer of debt instruments –respect the contractual financial commitments and other restrictive covenants, which restrict his freedom. Additional supervision i.e. control over the debtor provided for by the restrictive covenants on a debt contract should bring the creditor a higher level of certainty that the expected return on the creditor's investment will be realised. For the purpose of pursuing their vested interests, both types of investors (shareholders and creditors) exercise their influence on management boards which are in enterprises (corporations), as the most common legal form of engaging in economic activities, their agents (Flannery, 1998; Berger, Davies and Flannery, 2000). However, there is no guarantee that management operates in the best interest of shareholders and/or creditors. The agency problem may refer to the relationships management has with both groups of investors, when their interests take opposite courses. With the aim to reduce the gap in diverging interests as much as practicable, each group of investors reached out for particular activities undertaken for the purpose of containing this divergence but it results in agency costs for stakeholders (Brigham and Ehrhardt, 2005). Consequently, corporate governance becomes a dynamic process that calls for a continuing oversight by stakeholders over the activities carried out by the enterprise and the activities of the nature and scope adequate to safeguard their interests. Should such direct monitoring be insufficient, then the indirect, external control i.e. market monitoring comes to the fore when the shares issued by poorly managed enterprises become undervalued and the enterprise is a subject to a takeover or its creditors have to pay above-average interest rates as a surcharge for elevated risk. In this way, a step towards market discipline is taken, i.e. monitoring or oversight by market participants. The regulatory framework of Basel II has brought great expectations in relation to market monitoring by enacting the so-called Pillar 3, where additional disclosures and enhanced bank information transparency would contribute to effective exertion of market monitoring by investors. Financial institutions (and within the framework of financial institutions, banks in particular) are subject to investor (shareholder and creditor) control, as well as to additional – regulatory i.e. prudential supervision. Due to the specific characteristics of banking industry elaborated below, to conduct corporate oversight only, as is the case with other non-financial institutions would not suffice to ensure stability of the banking sector. The taking up and pursuit of the business of a bank (bank services) is by definition a risky activity and it makes it different from the activities pursued by non-financial institutions or even non-bank financial institutions. The reasons for inherent risk associated with taking up and the pursuit of the business of credit institutions are outlined below:[1]

Enterprises are not financed only by means of raising equity capital.

- Banks perform maturity transformation described as the activity of a bank that accepts deposits and investments of shorter term on average and places those funds as loans of a longer term with debtors (corporates). Since maturity transformation comes down to holding longer term assets than liabilities, it is one of the most important functions delivering major economic value, but creating risk. If all bank creditors wanted their money back on the contractual date (as seen in the case of the so-called "bank run"[2]), banks would not be able to honour their obligations, unless the central bank as the lender of last resort came to their rescue to bail out the financially distressed bank.
- Liquidity and solvency risks have a systemic character in the banking sector. When liquidity problems surface in one bank, it dents confidence in other banks and exerts influence on more prudent bank behaviour when it comes to the provision of liquidity to other banks. All this may influence liquidity pressures across the banking system and the intention shared by numerous banks to respond to those pressures by putting their liquid investments on the selling block. The pressure produced by the ample supply of liquid investments causes the prices of financial assets

[1] The list of the literature that addresses the inherent instability of credit institutions is very long. There is a concise description of the reasons for systemic risks at banks in The Turner Review (FSA, 2009).

[2] »Bank run« is the English term when customers of a bank fearing that the bank will become insolvent rush to its tellers' windows to take out their money to avoid losing it.

to tumble and may result in solvency problems of the affected banks.

• Findings suggest that a bank's credit portfolio is opaque in terms of information and its liquidity is low (Flannery, 1998, Crockett, 1997). The fact is that banks finance enterprises that, in turn, also demonstrate information opacity and, therefore, they are not eligible for tapping into capital market funding since the capital market expects and demands information transparency. Banks that operate in the financial markets bridge the information asymmetry and by obtaining private information on future debtors create the conditions for the assessment of their credit standing and the decisions to grant credit. The private information obtained in this way represents their information capital, which they do not disclose to other participants in the market. Consequently, banks as financial intermediaries are highly important for bridging over the information asymmetry and in the provision of external funding for the enterprises that need such funding for their operations.

Banks are crucial institutions in financial intermediation and a failure of a single bank that may cause distress to the rest of the banking system or jeopardise its normal functioning, is the most obvious externality. Therefore, to maintain the stability of banking institutions is a widely appreciate value that justifies the existence of additional regulations for bank operations and supervision of its conduct. It is believed that bank investors (depositors) are not in a position to oversee banks effectively through the market monitoring mechanisms (Flannery, 1998, Dewatripont and Tirole, 1994).

There are at least two rationales in favour of this thesis: first, depositors are not motivated to conduct market monitoring consistently, since their information costs are high and with a view of their atomisation they have also difficulties to co-ordinate one with another and second, bank credit portfolios are not transparent in terms of information; hence to assess the quality of their portfolios is a daunting task for market participants due to objective reasons. In other words, a financial investment, whose value cannot be assessed reliably due to the fact that information is not available (only the bank that makes loans based on the relevant information in its sole possession), are illiquid, since market participants cannot express its

Conducting supervision of banks means to "discipline" banks instead of investors.

quality by putting a price tag.

The following mechanisms have been deployed to "correct" the market shortcomings that hamper effective disciplining of market participants (banks):

- additional prudential regulation of banks' operations and supervision of compliance with the provisions of the regulatory framework,
- the systems put in place to insure deposits placed with banks for the purpose of fostering confidence of small depositors, and the last but not the least
- the possibility to be bailed-out by the lender of last resort intervention in case of illiquidity.

Conducting supervision of banks means to "discipline" banks instead of investors, that is, market participants, that is, due to the absence of the indirect market discipline policy or market monitoring. On the other hand, by introducing regulatory constraints on banks' activities, effective supervision by market participants is also hampered and prudential bank supervision is justified. To illustrate this argument we argue that the setting of restrictions i.e. by imposing authorisations for qualified bank shareholders reduces the clout of the market in exerting disciplinary effect on financially distressed credit institutions by means of take-over threats. Therefore, it is not only about losing an incentive to conduct oversight, but there are also institutional constraints, which stand in the way of producing an important disciplinary effect on the regulated and supervised financial institutions. Likewise, it is also true that by withdrawing prudential oversight, there is more room for conducting market monitoring. The findings made by Goyal (2003) suggest that there was an increased interest in monitoring performed by market participants in the circumstances created by relaxing prudential supervision as the authorised bank activities were in the 1980s in the USA. The findings arising from his survey paper indicate that the volume of the contract restrictive covenants regarding the issuance of subordinated bonds (debentures) has increased in the wake of the decision to give a loose rein to banks in running activities and to pursue more risk-prone strategies. Such a twist can be understood as the acknowledgement of subordinated creditors that assume the lion's share of risks in addition to shareholders, that in the absence of prudential supervision, they have to be pro-active and arrange for a higher degree of oversight of the debtor bank solvency[3].

[3] The question to be asked is why creditors would take initiative for oversight, if the bank has responsible shareholders. Shareholders are in favour of more risky strategies, since they are rewarded for risk-taking by above-average rates of return, whereas creditors are interested in more moderate, conservative strategies that do not threaten the bank's solvency.

Prudential bank supervision and market discipline are not perceived as the supervisory mechanisms where one mechanism could replace the other in full. As already mentioned, prudential bank supervision in way serves to correct the shortcomings of market discipline and from that point of view this oversight is "irreplaceable". Prudential bank supervision has certain advantages over the monitoring leverage of the market and vice versa. As a consequence, the question to be asked is whether we can use certain advantages of monitoring carried out by market participants for the regulated i.e. supervised financial institutions in a wider scope and in that way manage to minimise imposing significant cost on the taxpayer that would be the case in the event of financial instability. This question cannot be reversed to ask whether the scope of regulation and supervision can be significantly cut back or even phased out in favour of a bigger role of market monitoring. The mechanisms, which correct market externalities (savings deposit insurance schemes, lender of last resort facilities) mean that in the event of a bank failure, the government would have a claim on its residual assets. The fact is that by producing a guarantee for deposits, the government has actually given to the depositors as a gift the right to sell (put option), which entitles them to get from it a refund for their savings should the bank fail, and by doing so, the government becomes a creditor of the failed bank. Also in the event that the financially distressed bank should gain access to the central bank lending (the lender of last resort facility), the government can become a creditor of the failed bank. Prudential supervisory institutions supervise banks' activities with the purpose of limiting the bill to be footed by the government and eventually be borne by taxpayers in the wake of a bank failure. Bank failures would be more frequent in the absence of bank supervision also due to bank more risky behaviour (moral hazard) and such idiosyncratic risk-taking would be exacerbated knowing that risky operations may be rewarded by bringing financial benefits in the first place. On the other hand, a potential loss, should there be one, is covered by the government by deploying safety mechanisms and extraordinary measures taken with the aim to safeguard financial institutions, that is, financial stability.

Liquidity and solvency risks have a systemic character in the banking sector.

In sum, we may say that due to the importance of credit institutions and the need to maintain confidence in these institutions, the government has put in place particular protection mechanisms, which encourages market discipline or goes as far as to eliminate its shortcoming (externalities). By introducing new safety mechanisms (safety nets), the motivation of market participants to exercise oversight and discipline banks is dampened further; after all, market participants are aware that their loss is capped or even prevented as at the end of the day it is taken over by the government for the purpose of ensuring financial stability. A decision to phase out market monitoring would call for prudential bank supervision with the aim to minimise fiscal costs to be potentially borne by the government as the failed banking institutions need to be bailed out. Prudential supervisory institutions are better poised to conduct supervision of banking firms due to a number of reasons, of which the most important ones range from cost effectiveness and privileged access to information to high professional specialisation of staff, etc. On the other hand, prudential bank supervision has certain disadvantages in comparison with market participants. If bank supervisors are on par with the country's civil servants, then they are not well paid and consequently they are less motivated to do their job efficiently. The response on the part of inspectors/examiners to identified problems is lower due to rigid procedures and extensive regard for the principle of equity. When using this yardstick, market reactions are more effective since they are immediate and intensive.

There is another rationale in favour of state oversight i.e. prudential supervision and it has come to the fore particularly in the wake of the global financial crisis. A number of financial institutions and most frequently this refers to banking firms, have become so large and systemically important (»too-big-to-fail«) that their failure would have far worse financial consequences that the costs to be borne to keep them afloat. With regard to such institutions, there is the explicit or implicit guarantee of the government designed to safeguard all their creditors, which makes market discipline in such cases futile, i.e. market discipline de facto does not exist. Moreover, the bank regulator/supervisor has transmitted too clear signals saying that financial stability will be sheltered no matter what the price may be, and by doing so, the supervisory authority has cemented its role of a bank supervisor whose mandate is to minimise the costs to be borne by taxpayers in the event that so important banks should fail.

Those championing the opposed view arguing that the behaviour of market participants when taking over risks should be more responsible and market discipline should be given a more prominent role of (Crockett, 2001; Freixas, 1999) talk about "constructive ambiguity". The doctrine means that central banks do not commit to a specific policy, whereby there is no public announcement on what the bailout policy of a financially distressed bank will be and their higher discretionary right to decide as to what sort of intervention will be used to resolve financial distress. Such a policy should stimulate market participants to act prudently when taking decisions about investing their money and in favour of a higher degree of investor oversight over a bank during the life of the investment. Furthermore, the effective implementation of both activities is connected with the availability of adequate information used by market participants to make assessments, i.e. monitor the bank and by doing so increase the clout of market discipline. If there is a guarantee for savings deposits in place, the readiness of the central bank/ regulatory authorities to safeguard systemically important credit institutions and bank supervision, then the motivation of market participants to conduct oversight is diminished and instead they rely on bank supervisors to discipline the banks ("free ride").

2. Market discipline as a form of supervision

The market may influence financial institutions very effectively through the leverages at its disposal. The most important leverage serving to let the market impact the financial institutions are prices and the availability of financial savings.

2.1. How is market discipline manifested?

Market participants through changes in prices communicate their assessments of a bank's level of risk associated with the expected cash flows from investments and thus influence also the issuers of financial instruments. The most drastic market reaction is seen when investors on the grounds of what they assess as excessive risk, refuse to invest in a particular financial instrument.

An absence of market transactions could be interpreted also as if there were no market

Should investors believe in general that investing is fraught with risk and move their money into safe investments or fully insured accounts (»flight to safety«), then this type of market reaction leads, as a rule, to a financial crisis. The crisis that erupted in autumn 2008, is a manifestation of such market reaction resulting in the situation where certain segments of the financial market simply froze (e.g. trading in securities derived from securitisation processes), while other financial market segments shrunk significantly and consequently impaired the function performed by financial intermediaries. Should that happen, it is referred to as a market dysfunction, i.e. imperfect distribution of information (»market failure«), where as a result of a high level of uncertainty (shortage of information required to assess risks) market participants largely react by making smaller amounts of financial savings available for risky investments and to a lesser degree command price changes. An absence of market transactions could be interpreted also as if there were no market, i.e. that the market has failed. On the other hand, such a reaction of market participants still sends a signal, i.e. provides information. After all, it was the market who sent a warning and thus reacted on the piled-up disparities or imbalances in the financial system, which backfired in the most recent financial crisis and not the prudential regulators.[4] The efforts made by the regulatory authorities to deploy emergency measures with the aim to mitigate the consequences of a market failure should not be interpreted as interventionism devised to take the place of the market mechanism, but as commitment to restore fully functioning markets. It is also difficult to understand market sceptics arguing that, among other factors, the unwinding of the financial crisis could be pinned also to the inadequate market functioning since the market failure has enabled disparities/imbalances to accumulate. One should bear in mind, however, that the market operates on the basis of the judgement made by numerous market participants and other institutions that generate relevant information for market decision-making. Clearly, at the heart of the problem there is the collective assessment/ judgement of the market made on the basis of incomplete information, even though, as already mentioned, at the end of the day the market managed to identify the financial distortions (by getting fresh information) and was able to react accordingly.

[4] Even the stance adopted by the IMF experts regarding innovation in the banking system was too benevolent with pointing out merely advantages. For more details, see the Global Financial Stability Report, IMF, April 2007.

The functioning of the market and the quality of market discipline depends in many ways on the availability of information used in the decision-making process. Typically, market participants react at every new piece of information regarding the riskiness of their investment by price changes. It is crucial that investors are exposed to risk and therefore to the possibility that the expected cash flows would not be realised and should that be the case, not only their return on investment would be at stake but they would also risk to lose the invested principal, i.e. capital. How effective the financial market may be when benchmarked against the information available, i.e., what is the information effectiveness of the market has been the topic of numerous empirical studies. Irrespective of whether we are dealing with information effective or less effective markets, it should be emphasised that for the supervisors of financial institutions, prices being a result of the market participant interactions may serve as a valuable source of additional information both for the need to make an assessment of changes in the riskiness of individual institutions and also for the analysis of financial stability. What make market information (prices) such a valuable source of information for bank supervisors and financial analysts? Market prices are a result of the interaction of the numerous participants in the market (here we are referring to the markets that converge with the conditions of full-scope competition) and these market participants take decisions by using information from various sources and they process such information so as to serve them in taking informed decisions. It would be an act of contempt, if one disregarded a myriad of well-contemplated decisions taken by the market participants, even though many a critic would argue that a host of decisions has been made in the stock markets as a consequence of "herd behaviour". True as it may be that this statement might apply to uninformed small investors, it would be reckless to argue that this principle prevails among professional investors. A myriad of information, assessments, decisions passed and at the end concrete transactions results in prevailing prices that send a message about investors' opinions regarding the riskiness of the institutions in which they invest their money. Market prices do not appear once and for all in long-term discrete time intervals (for instance on a yearly, quarterly or monthly basis), but trading in the liquid markets is a continuous process. Prices, which are a result on continuous trading, do not become obsolete, but each time they reflect available information and opinions of the market participants. Unlike reports sent to bank supervisors at stipulated intervals, prices are constantly available and reflect current responses by transactors. We have already mentioned that transactors use information from various sources when taking informed decisions and they analyse and process such information for the purpose of taking concrete decisions. At this point it is worth mentioning that the information is not based on the past events only but often information comprises also an element for the assessment in relation with the outlook for the future. It is the latter attribute that gives market prices a special quality advantage over official reports submitted by the regulated/supervised financial institutions to their respective supervisors and containing only the information about past events.

It is the weight of the attributes described above that makes market information a significant complementary source of information for the supervisors of financial institutions. Market information is equally important for the financial institutions in their own right, as well as for significant financial markets participants. Investors send them signals about their position regarding their riskiness and they express their opinions through price changes or in extreme cases also by cutting back their disposable financial savings. Consequently, the market takes a role played by the bank supervisor to discipline banks. Risk increase as a consequence requries a higher expected return or lower prices as a result and thus it directly constraints increasing risk in excess of the limits still acceptable to investors. Theoretically speaking, market discipline may partly complement or in the most extreme variant even substitute prudential bank supervision of financial institutions, if the conviction prevailed that investors actually do respond to a change in the level of risk associated with the financial institutions and have a similar motive as bank supervisors: to avert insolvency. There are numerous sources of market information. The most appropriate and the most frequent are the prices of securities issued by financial institutions. The opponents of the use of market information to discipline the regulated/supervised financial institutions underline the fact that in the aggregate bank population the number of those whose shares are listed in the regulated markets is relatively small, and the number of regularly traded bank bond issues is even smaller. A rationale opposing this way of reasoning is the fact that a change in bank riskiness is not influenced only by return, i.e. the prices of shares and bonds, but also by interest rates paid on other types of debts: deposits, interbank lending, and subordinated debt. What is crucial here is that investors in these instruments are aware that by investing in such instruments, they assume risk. Should that not be the case and investors were convinced that their invested funds cannot be lost thanks to the arrangements to provide explicit or implicit guarantee of the authorities, it cannot be expected that the disciplinary power of market participants would exist at all. Should that be the case, there would be no informed assessment/judgement regarding the intended investment and also the market price would not reflect changes in riskiness; therefore, its useful value would be small. The impressions shared by investors that they are immune to risk, if they invest in systemically important financial institutions, is even more pronounced in banking industry. It is often the case that authorities are wary of the possibility that prominent credit institutions in the event of bank financial distress could jeopardise the entire banking system and consequently cause social distress, is often present.

2.2. The objectives of introducing market discipline in prudential bank supervision

Before the financial crisis and the economic crisis that followed suit, the intentions to open the door to a higher degree of influence of market discipline on bank operations were pronounced and numerous. By putting in place Pillar 3, the rules adopted under Basel II showed the unambiguous intention to assign a more prominent role to market discipline also in the area of bank regulation and supervision and by becoming more important complement Pillar 1, which stipulates the minimum capital requirement based on the risks to which a bank is exposed and Pillar 2, within the framework of which bank supervisors in dialogue with the bank assesses its capital adequacy benchmarked against its risk profile. The intention of Pillar 3 of the New Accord has been to ensure additional information on various aspects of bank risk, and market participants could use such information to assess a bank capital adequacy and by doing so also test their readiness to invest in it. In addition to regulators, numerous initiatives have been made by experts, market participants and even banks themselves with regard to the need to increase the influence of market discipline on banking operations. The main motive underlying such initiatives has been to pave way to market discipline to become so important to the point of gradually taking the place of the minimum capital requirements under Pillar 1 (Tarullo, 2008). These ideas have been even operationalised by means of financial instruments designed to deliver quality market discipline to the highest possible extent. In this context, the largest backing has been given to the subordinated loan instrument to be issued by banks as a mandatory instrument with the aim to expose them to market discipline. Why should banks issue subordinated debt? First, subordinated debt ensure a higher level of stability for the bank, since by investing in this debt instrument investors assume the risk of sharing in any loss to be incurred in the course of a bank's operations and by doing so, they shelter other creditors. In a nutshell, for the bank, the subordinate debt instrument represents quasi capital.[5] Second, the interests of subordinated debt holders are very similar to the interests of savers with their money in banks or more specifically, the interests of the institutions, which guarantee for deposits placed with banks by small investors; therefore, the public interest. The risk profile of the ordinary creditors that invest in banking firms is that they may count with the agreed interest, which is capped, but on the other hand, they may even lose a portion of the principal (unless it is not insured within the framework of deposit guarantee scheme). The risk profile of the holders of subordinated debt is similar: positive return is capped by the rate of interest paid on the debt, while the probability that in the event of poor performance they would be stripped of a portion of the principal or the principal as a whole is even higher than for ordinary creditors, since they come right after the shareholders to bear the consequences of a loss. The question to be asked is why not float bank shares on the stock markets with the aim to ensure a higher influence of market discipline? After all, by investing capital in banks, their shareholders are most exposed to risk. The latter is undoubtedly true but the biggest obstacle standing in the way is the very risk profile of bank shareholders: they stand to reap yields, which are not capped and thus have an upside potential, whereas in the event of the bank's poor performance, they may lose the invested capital. It is the very risk profile that makes bank shareholders prone to risky strategies that promise to bring them above-average rates of return. This is the point where their preference differ from the creditor preferences (ordinary or subordinated): creditors subscribe to more moderate, in other words more conservative strategies for bank operations and thus restrain moral hazard enabled by the system of deposit insurance. By taking into account the characteristics of subordinated debt and its alleged positive influence through the market discipline mechanisms, certain bank regulators have even stipulated the mandatory issuance of subordinated debt that via the influence through price signals, contractual commitments and other channels would make banks pursue moderate strategies, which ensure

[5] One should keep in mind that subordinated debt is liability by nature with a maturity date on which the principal falls due and that interest rate exceeds the interest rate paid to ordinary creditors.

stability and solvency of banks.
Market discipline may exert influence on banking institutions directly and indirectly (Tarullo, 2008). The direct influence is described as the market influence on bank management through price changes or the covenants of a debt contract that restrain management in assuming excessive risks. The indirect market discipline influence exists when a bank supervisor uses market information (such as, for instance, the analysis of changes in market prices) as additional information serving to facilitate assessing changes in risk profile of banking institutions and/or to deploy these signals as triggers for paying more attention in the early-warning systems. Both channels for the functioning of market discipline, direct and indirect, attracted much attention in the run-up to the crisis and enjoyed strong support. The enthusiasm generated by the two channels went so far that the possibility of phasing out the minimum capital requirements from Pillar 1 of Basel II in favour of an ever-increasing influence of market discipline on bank operations was on the table and the market-based mechanism would be put in place through the mandatory issuance of subordinated debt. The most ardent enthusiasts argued that it would provide a way around the complicated advanced IRB approach used for the calculation of capital requirements and hardly understood by anyone save for few bank officers.
However, the direct influence of market discipline cannot be taken for granted as it may appear at first glance. The influence i.e. the action of the subordinated creditors through covenants on a debt contract is a demanding task associated with high transaction costs. It may result in above-average costs of such borrowing (rate of interest), which, in turn, could indicate a higher bank risk.
The expectations were not as broadly channelled through the covenants on a debt contract as they were into the effect produced by the price of borrowing (rate of interest) on the bank management behaviour. If a bank is perceived by the investors as being risky above the average, then investors will demand higher interest rates or they would not be ready to invest in its instruments at all. Such a perception by investors should have an effect also on the bank's management averting them to pursue excessively risky business strategies. This concept has also proven to be associated with numerous dilemmas at the operating level. Should we wish price changes to have influence on management behaviour, then it would be necessary to stipulate mandatory issuance of subordinated debt in certain intervals. Seen from that angle, market information based on share trading is a better indicator since trading reflects the information possessed by the holders of stock on a regular basis and promptly each time a change takes place. Trading in subordinated debt is far less liquid or there is none whatsoever since the subordinate debt holders monitor the debt-issuing bank and honouring of the covenants in a debt contract and hence there are not many inquiries by other investors. Mandatory issuance of subordinated debt raises the question whether a bank needs such funding at all. If the bank has sufficient equity, then the mandatory issuance of subordinated debt means gathering less deposits and increasing funding costs. If the subordinated debt should be a substitute for equity, then the bank's financial leverage would rise instead of being restricted as post-crisis findings have indicated. There is no doubt that the rules proposed under Basel III speak in favour of this finding.
Further to the subordinated debt, there are voices demanding to examine how investor interests coincide with public interest. It is common wisdom that public interest is broader (systemic importance, stability) and it would be better served by subscribing to more conservative monitoring of bank management, that would, in turn, affect the effectiveness of the bank's performance. To narrow the positive effects of market discipline merely on the subordinated debt could also be in conflict with public interest, since it could be exacerbate to the point where the effectiveness of financial intermediation might suffer. And the last but not the least, the empirical studies fall short of a straightforward answer to the issue of the direct influence of market discipline on management behaviour. A number of studies have shown that market prices reflect the bank's risk profile, but not so many studies have proved the existence of the functioning of the direct market discipline channel, particularly under the circumstances of ordinary operations when banks are not exposed to potential insolvency procedures.[6]
Not so many dilemmas have sprung up in relation to the functioning of

Market discipline may exert influence on banking institutions directly and indirectly.

[6] Bliss and Flannery (2000) conducted the empirical study, but came up only with weak evidence of direct influence of prices on bank management behaviour.

the indirect market discipline channel. This aspect has prevailed also in relation to the proposals advocating mandatory subordinated debt issuance that would contribute to better supervision and disciplining banking institutions. The analysis of the fluctuations in rates of interest paid on subordinated debt (in other words the surcharges on a reference rate) would provide bank supervisors with additional information acting as a trigger in the early-warning system. It should be said that additional market information would be hardly likely to do any harm. As a matter of fact, the usefulness of market information could be extended to all instruments issued by banks and traded in regulated markets. It seem exaggerated to expect that the quality of market information would be high enough to have the indirect aspect of market discipline substitute the capital ratios laid down in Pillar 1 and calculated by taking into account a bank's risk-weighted assets (US Shadow Financial Regulatory Committee, 2001). Without regard to the shortcoming of the calculation of the capital requirement based on the risk-weighted assets (the complexity hard to understand by non-bank investors, takes into account only credit, market and operational risks, and the information is available with a lengthy time distance), it could be argued that to substitute this system with indirect market monitoring would be less effective since the approach has also certain obvious shortcomings (Tarullo, 2008).

One of the shortcomings is the issue whether market prices include explicit or implicit guarantee of the government for deposits placed with banks. The issue of the implicit guarantee is particularly interesting since it is connected with the bank's systemic importance, i.e. with the problem known as »too-big-to-fail«. In the case that investors believe that the government or a regulator will uphold a financially distressed bank at any cost, then the market prices will reflect this perception by being less sensitive to the changes in the bank's risk profile. Another shortcoming is associated with other influences, which market prices possibly reflect and which have no correlation whatsoever with the changes in the level of risk of a concrete financial institution (more stringent market conditions, specific features of local markets, macroeconomic situation, ...). From the supervisors' standpoint, a question should be asked about the quality of additional information provided by market prices. Market prices are generated on the basis of the information possessed by investors and they, in turn, dispose of a limited scope of information on the bank's investments and its business. Bank supervisors, on the other hand, dispose of all information and there is logical question that comes to mind: does additional market information constitute any added value at all? Everything we have said so far indicates serious shortcomings even though these shortcomings should not deter regulators from using market information as an additional analytical tool for the analysis of bank riskiness. On the other hand, indirect market discipline is neither a sufficiently reliable or robust system with the attributes required if it were to replace the minimum capital requirement from Pillar I.

The indirect market discipline channel also has its cutting edge. Since the basis for this channel are the assessments of numerous market participants reflected in the current market prices, it has the attributes necessary for the provision of up-to-date information on market perception regarding risks. This piece of information is not subject to the supervisors' discretionary rights and consequently restricts their feet dragging when action should be taken when there are signals indicating the need to act. Market participants asses all aspects of riskiness by taking into consideration information from the past and the assessment regarding the future. For the bank supervisors who largely build their assessment on the reports released by banks for the past periods, market information may be a new quality in their judgement. Not least of all, it has been proven also by the empirical studies whose findings suggest that the pricing, i.e. surcharges are more sensitive to changes in the riskiness of banks than capital adequacy ratios (Goyal, 2005).

3. Conclusion

There is little doubt that market discipline has plenty of untapped potential in corporate control of banks (corporate governance). Here we are not referring to the numerous ideas, which have been given in relation to mandatory subordinated debt issue and the possible replacement of the capital requirements from Pillar 1 with market discipline. Such initiatives appear to us as naive and "rough on the edges". After all, such initiatives have been eliminated by adopting regulatory modifications under Basel III, which have enhanced capital requirements from the so-called Pillar 1 even further. Market discipline, i.e. tapping into market information is understood as an addition to the supervision and corporate governance of banks already in place and by no means their substitute. Further to the subject, it is our position that narrowing the roster of instruments to particular instruments only (e.g. subordinated debt) is a short-sighted measure and therefore it makes little or no sense. To this aim, a myriad of market information should be used given the fact that each piece of information may reflect risk associated with the respective bank in its own way and it may therefore add a new quality to the risk analysis. Growing interest in the use of market-related oversight does not mean market glorification. The market mechanism has certain specific shortcomings in relation to the business of banks: there is a substantial asymmetry of information, banks have high financial leverages, they provide the most important external source of financing to enterprises; hence they have strong financial links with the enterprises, banks are eligible for explicit or implicit state guarantee for deposits, and similar issues). As a result of all the aforementioned shortcomings, banking industry is sometimes a breeding ground for moral hazard; in other words, private and public costs and benefits may move in opposing directions. The market does not function optimally under such circumstances: therefore, it is necessary to eliminate the aforementioned shortcomings to the highest degree possible. By enhancing transparency of operations, disclosure of information, and possibly even by exacerbating investor uncertainty about lender of last resort interventions to banks in distress, should sharpen investor ability to assess whether the contemplated investments are worth making. Irrespective of all drawbacks, market information is already at present a useful additional tool for bank supervisors for assessing a bank's risk profile. And last but not the least, bank management is far from being immune to the signals arriving from the market, even though it is a statement made at this point of time largely on the basis of intuition.

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Stress testing in macro environment

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STRESS TESTING IN MACRO ENVIRONMENT
Stress tests are useful tool for estimation of operating environment of banks, latent risks and the potential impact of individual shocks on credit market, securities, interest rates, foreign exchange market, capital and quality of loan portfolio. They estimate potential shocks, latent exposures and hidden risks of credit derivatives. Stress tests act - as modelling of risks - on the basis of tailed events and distribution of past events. The multiple factors of risks are included into estimation as the measure of probability of individual events. The stress test can be divided into sensitivity analysis (explained by relevant economic variables), scenarios (explained by marginal and possible scenarios) and contagion (the transmission of individual exposures on the system). Stress tests are also complementary to the supervisory early warning system. Stress tests are an indicator of exposures and not a forecast.
Key words: vulnerabilities, contagion, scenarios, sensitivity analysis

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Better understanding of the vulnerabilities in financial systems, especially banks, is enabled by techniques for quantifying vulnerabilities - stress testing - that are used as risk management tools. Stress tests are useful tools for evaluation of the different effects and their impact on financial condition of individual bank or the whole banking system, in the cases of certain scenarios.

Introduction

To assess the credit risk inherent in banks exposures abroad - from the point of financial stability view - we have to implement the stress testing to determine how banks react if the shocks in market arise. The future development of banks environment - that potentially pose a risk (especially for the credit, securities and foreign exchange markets) for the credit institutions - is estimated by stress tests. The consequences of different shocks are presented as scenarios of different risk factors. Estimations are referred to macro stress testing and scenario analysis, meanwhile the sensitivity analysis is based on the estimation of a subset of risk factors.

Stress tests have been developed for estimation of factors influencing the value of portfolio dynamics. The sensitivity of financial institutions or group of them on common shocks is measured.

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Compared to stress tests for individual institutions, the macroprudential stress tests have broad coverage: the system as a whole or large part of it is included in the estimation; aggregate level surveillance is used rather than risk management in individual institutions; and a contagion among institutions is focused.

The notion between exceptional and plausible event is important in the definition of stress testing. The stress test can be viewed as a risk modellling focusing on "tail" events, as methods such as value at risk (VaR) and a comprehensive risk model as complementary methods. From the other hand, stress testing can be viewed as approach that evaluates the distributions of past shocks used in VaR. And the middle road is involved to difficulties with designing a stress testing scenario (especially for multiple risk factors) based on a measure of plausibility (more in Sundararajan et all., 2002, Blaschke and Jones 2001, Sorge 2004).

We can divide the stress tests according to methodology into three main types: (i) *sensitivity analysis*, which estimates impacts of dynamics of relevant economic variables; (ii) *scenario analysis*, which assess the impacts of exceptional but plausible scenarios; and (iii) *contagion analysis*,[1] which take account of the transmission of shocks from individual exposures to the system as a whole (more in Čihak 2005).

We need to combine stress tests with quantitative information on the financial system, qualitative information on the institutional and regulatory framework, information on the structure of the system, macroeconomic indicators and the financial soundness indicators (of corporate and household counterparts). The aggregated individual institution data and indicators that are representative of the markets - in which the financial institutions operate - have to be included.

In the paper we present the short overview of stress tests performed by international financial institutions and implementation of stress tests regarding the individual shock factors.

1. Stress testing overview of international financial institutions and central banks

The International Monetary Fund and the World Bank have initiated the *Financial Sector Assessment Program* (FSAP), which strives to assess strengths and vulnerabilities in their member countries. Single-factor sensitivity analysis - based on historical extreme values – is using multiple techniques to determine the size of shocks. The experience of the FSAP suggests that the types of stress tests need to be tailored to country-specific circumstances, the complexity of the financial system and data availability. There is substantial cross-country variation in the sizes and range of shocks covered, as well in the methodologies applied. The stress tests in FSRs show some common features (Čihak 2005):

- a)The stress tests tend to have a wide coverage of the banking sector; other parts of the financial sector are covered only exceptionally.
- b) Virtually all presented stress tests are based on bank-by-bank data. The stress tests are missing some potentially important risks arising from concentration of risks in weaker institutions.
- c) Credit risk and interest rate risk are covered in almost all stress tests. Exchange rate risk is covered in many cases and it is analyzed only in terms of open positions.
- d) Most stress tests are simple sensitivity analysis calculations. Some include scenario analysis, based on historical or hypothetical scenarios. Inclusions of indirect exchange rate effects and contagion are rare.

A number of central banks in CEE have started to conduct macroprudential stress tests and publish their results as part of their analyses of financial system stability.

The central bank of Poland estimates the following simulations for credit risk: simulation of the percentage of loans extended by domestic commercial banks and their impact of rating on the capital adequacy ratio; simulation that measures the impact of loan collateral on the capital adequacy ratio (estimation is made for the ten largest banks in Poland); simulations designed to assess the effect of bankruptcy (of the three largest borrowers) on financial stability; and interbank contagion risk with econometric macro-model, which simulates a deterioration in the financial position of banks' clients and takes into account an increasing competitive pressure related to the relatively high pace of loan growth. The central bank of Hungary addresses stress tests for credit and contagion risk in the interbank market regarding credit risk for the household and the corporate sector. The central banks of Romania and Russia estimate models, which are based on macro stress tests. The central bank of Romania takes into account second-round effects of a depreciation of the domestic currency and of interest rate movements (for domestic currency lending) in a credit risk stress test. The central bank of Russia and Slovenia conduct sensitivity analyses and macro stress tests. The Central Bank of the Czech Republic practises sensitivity stress tests based on two scenarios: macro stress tests using consistent model scenarios and stress test for interbank contagion.

[1] Aggregate stress tests evaluate shock's impact on capital ratio of banks; further failure of individual banks impact the matrix of interbank exposures. The second round bank failures are triggered by contagion (see, Čihak et all. 2007).

In Austria, Poland, Latvia and the Czech Republic all banks are covered and included in the stress test analysis, in Germany and Denmark only a sample of banks; and in Netherlands, Norway and Sweden only the largest banks and major conglomerates, while Hungary includes all the active banks. Credit shock is included into estimation in Austria, the Czech Republic, Denmark, Hungary and Latvia. Poland estimates the credit shock regarding to satisfactory and special loans that migrate, substandard and doubtful loans and bankruptcy of larger borrowers. Norway includes a decline in economic and employment growth, while in Sweden they take into account a failure of the largest counterparty and assumed recovery ratio. Interest rate shock is taken into account by observing shift in the EUR, USD, CHF and YEN curve in Austria, by combination of weighted yield gaps and duration methods in the Czech Republic, by average lending rate in Denmark and Netherlands, by twist of the yields curve, parallel shifts across all maturities and fluctuations in the medium range, by domestic and foreign rates gaps in Hungary, by analysis of interest-sensitivity instruments and maturity of debt securities in Poland, by stock market dynamics and interest rates abroad in Sweden, by interest rate burden home and abroad in Norway etc. Exchange rate shocks are included and estimated by different methodologies in the most economies. Among other shocks, we can mention equity price dynamics, which is included in Austria, Denmark, Germany; property market risks and equity prices in Poland and Norway; changes in relevant stock indices in Netherlands. The effects of contagion are estimated in the Czech Republic, Austria, Sweden and Netherlands.

1. 1. Implementation of stress testing

In the context of macroprudential analysis, the stress testing refers to a wide range of statistical techniques to assess the vulnerability of banking system to plausible events. Approaches used can be VAR (probability of deviation from the expected profit, potential losses regarding the volatility of prices), gap (interest sensitive assets and liabilities, sensitivity of financial instruments on interest rate changes), duration (sensitivity of assets and liabilities on duration gap), »what if« (sensitivity of relevant variables on interest rate changes, yield curve, exchange rate and other conditional events) and market approach (methodology for evaluation of capital) (see, Čihak et all 2007). For simulated economic environment a conditional probability distribution of losses can be estimated. As a summary statistic, the value-at-risk measure is often used to quantify the sensitivity of the portfolio to different sources of risk (see, Čihak et all 2007, Čihak 2005, Sorge 2004). Macroprudential stress testing can be seen as a multi-step process, which involves identifying the major risks, exposures in the system and defining the coverage, calibrating the shocks, selecting and implementing the methodology, and interpreting the results (see, Worrell 2004, Goodhart et al. 2003, Čihak et all 2007). The fact that there are macroeconomic risks that could result in shocks to the financial system does not necessarily mean that the impact of the shocks would be large. In terms of exposures, the most frequently covered are exposures to credit risk and market risks, and sometimes also liquidity risk and interbank contagion risk. There are two ways of asking questions about exposures in the financial system: a level of plausibility, what scenario has the worst impact on the system; and an impact on the system as the most plausible combination of shocks that would need to occur to have that impact. The worst case approach starts with selecting a level of plausibility (e.g. 1%), and searching for the combination of shocks with level of plausibility that have the worst impact on the portfolio. Calibrating the shocks is particularly straightforward for single-factor stress tests. With multiple risk factors, one needs also to look at the covariance statistics of the variables, or use stochastic simulations based on macroeconomic models (see, Čihak 2005).[2]

The stress test can be viewed as a risk modelling focusing on "tail" events.

Some authors argue that stress tests should be based only on historical variance and covariance patterns, the others agree that there can be plausible scenarios that have not yet happened. In practice, future crises can go beyond historical experience. New crises may include new concentrations of risk emerging through cross-market linkages. Simulating shocks are suspected to be more likely to occur than histori-

[2] The first way to formulate an extreme scenario with a choosen degree of plausibility is the approach called »worst case approach«, which explores the scenarios that have the maximum impact for a given level of plausibility. The »threshold approach« presents the largest shock that leaves the system above a certain threshold. And practical approach states that establishing the exact level of plausibility of a shock or scenario can be difficult (Čihak et all. 2007)

cal observation suggests; or reflect a structural break that could occur in the future. A combination of a historical scenario with sensitivity analysis (i.e. alternative assumptions about individual shocks). provides an anchor and an assessment of the robustness of the scenario's results respecting the changes in the model assumptions.
Individual risk factors (exchange rate risk – direct and indirect, interest rate risk, credit risk etc.) and interbank contagion affect the financial institutions assets, liabilities and off-balance sheet items. The direct exchange rate risk can be assessed using net open position in foreign exchange. The indirect exchange rate risk is often more significant than the indirect one, because the direct is relatively easy to measure. The impact of changes in interest rate is measured by the repricing gap. The effect of the asset reclassification on the capital adequacy ratio is calculated after deducting the additional provisions from assets. Further, the most challenging step in designing a liquidity test is identifying which assets - that are considered liquid -may become illiquid in periods of financial distress. And, the interbank contagion stress tests can be performed like: (i) pure interbank stress test – where the impact of one bank failure is seen through the interbank exposure; and (ii) integrated interbank stress test – where the banking system is first subjected to macroeconomic shocks.
The indicators of systemic risk can be estimated from the output of the pure interbank stress test: frequency of bank failure indicator, statistical measures of the impact of the banking system capital. Systemic risk index can be defined as average reduction in capital ratios of banks in the system triggered by a failure of a bank.

1. 2. Individual factors regarding credit risk

Approach to macroprudential stress tests for credit risk require data on loan performance and data on borrowers (Sundararajan et all. 2002). The macro-prudential analysis is conditioned by macroeconomic data and market-based data (see, the text below). For adequate macro-prudential analysis we also need qualitative information (compliance with standards) and structural information

Credit risk and interest rate risk are covered in almost all stress tests.

(ownership, relative size etc.) [3]
The majority of studies have confirmed that GDP and export growth is a major challenge to loan portfolio quality and the dynamics of the non-performing loans (NPL) have been shown to be procyclical with respect to economic growth (Borio and Lowe 2002).
The interaction between the income cycle and (banking sector) size cycle is significant and negative correlated, implying that the negative relation between business cycle and capital adequacy is larger in economies with lower income and lower level of financial development, and vice-versa. We could expect the positive and significant effect of the cycle on asset quality in economies with a relatively lower level of financial development. The positive effect dampened in low income economies and lower financial depth, implying that the negative relationship between the business cycle and capital adequacy ratio is smaller in economies with a higher quality of supervision (Babihuga 2007). Heterogeneity across economies might prove different relationship between asset quality and the business cycle. The higher the banking sector concentration, the more foreign direct investment (FDI) in the financial sector comes from abroad and the higher the financial sector depth, the more possibilities the banks have for offering more credits and creating lower capital adequacy (Babihuga 2007).
The empirical record associated with an explicit analysis of the (net) foreign currency assets and exchange rate to NPL relationship is mixed, partly as a result of economies` different degrees of foreign trade openness, as well as with dissimilar (foreign currency) debt exposure in individual sectors. The worsening of banking sector mismatches and NPL ratio could occur - when borrowers borrow in foreign currency (or their loans are nominated in foreign currency) and payback credit in domestic currency - due to the shortage of foreign currency assets and domestic currency depreciation that increases the debt burdens (De Nicolo et al. 2003).
Capital inflows could result in an expansion of domestic credits; and a sudden withdrawal of bank deposits leaving domestic banks illiquid might take place after a period of large inflows of foreign short-term capital when domestic interest rates fall, when depreciation is expected or when confidence in the economy wavers, when disruption on financial markets or a balance of payment crises is expected (Calvo and Mendoza 2000).

[3] The capital, capitalization, profit, net interest income, liquidity indicators, solvency, rating and probability of default, nonperforming loans, net open positions as well the loan losses can be stressed.

The impact of savings with banks on the quality of a loan portfolio is ambiguous. Low bank capitalization (and low savings with banks) can often lead to the adoption of imprudent lending strategies with direct implications for banks' loan portfolios, which tend to be heavily skewed towards high risk projects. On the other hand, high savings with banks offer ample liquidity and enough banking finance to offer more credits to the private sector (Babihuga 2007).

Applying soft budget constraints may lead to considerable losses in the economy, when investments turn out to be counterproductive or when the household's liabilities/income ratio is extremely high (Kiss et al. 2006). The share of banks' loans to the private sector in total banking assets is considered as a proxy of risk taken by the banks. Loan-assets ratio is positively correlated with banking problems (see, Männasoo and Mayes 2009, De Nicolo et al. 2003, Fofack 2005).

There is a wide range of approaches to modelling credit risk. The choice for variables in the stress test reflects the evidence provided by the large amount of empirical literature confirming that a deterioration in banking sector results and credit quality is transmitted from the macro economic environment (Uhde and Heimeshoff 2009). Čihák et al. (2007) suggest (besides banking sector indicators such as capital adequacy, credit risk, and other relevant factors) incorporating relevant macroeconomic explanatory variables in order to perform stress testing of credit portfolio quality.

Blaschke and Jones (2001) discuss the impact of GDP growth and the business cycle on credit risk and also on the quality of bank loans. Männasoo and Mayes (2009) show that declining GDP growth and the instability of external and internal environments leads to a worsening of banking sector results and financial stability indicators. Similarly, Gambera (2000) revealed the link between macroeconomic dynamics and bank asset quality. Gerlach, Peng and Shu (2005) found that the non-performing loans (NPL) ratio rises with an increasing number of bankruptcies, but decreases with economic growth and property price inflation. Quagliariello (2003) argues that decreasing real GDP growth and increasing unemployment have a significantly adverse effect on loan portfolio quality, while the real exchange rate fails to affect it significantly.

A key issue for further work is to improve credit risk modelling.

According to the empirical study of Jakubík (2007), the default rate for the corporate sector is determined by the increase in the loan to GDP ratio; meanwhile, the default rate for households deteriorates via unemployment and compensation to employees. Zeman and Jurča (2008) claim that a slowdown in GDP growth can not be expected to substantially threaten the banking system. Hoggarth, Sorensen and Zicchino (2005) have seen the dynamics of inflation and interest rates as the important factors indirectly influencing financial stability and loan portfolio quality. Ferreira (2008) comments that an increasing deposit to loan ratio might be an indicator of decreasing the NPL ratio. The loan to asset ratio is positively correlated with banking problems, increasing NPL ratio and (in)solvency as a result of a bank's long-term mismanagement. The banks may offer more credit to clients having more time deposits in banks; or, if available, banking finance comes from abroad. Podpiera (2006) found a significantly positive impact of higher compliance with the Basel Core Principles on banking sector performance, as measured by NPL. Meanwhile, Babihuga (2007) argues that the relation between the business cycle and capital adequacy is more ambiguous; and appears to be countercyclical. According to Babihuga (2007) the more FDI in the financial sector comes from abroad, the more possibilities there are for banks to offer more credits and reduce capital adequacy. The author further discusses how the negative relationship between the business cycle and capital adequacy ratio is smaller in economies with a higher quality of supervision.

Instead of conclusion

The stress tests estimate the change in the value of financial assets and derivatives on the basis of market-to-market approach, while regulatory capital requirements often rely on book values. They show potential exposure to extreme shocks and potential losses. Stress tests need to be tailored to individual circumstances depending of the prevailing macroeconomic risks in an economy, the structure of financial system and data availability. Therefore they are difficult to compare between the economies. A key issue for further work is to improve credit risk modellling. System - wide stress tests are designed to assess the stability of the system as a whole. In that case, stress tests do not cover risks that are specific to individual institutions; on the aggregate level they provide approximate results. They do not take into account the moral hazard and supervisors responses to external shocks.

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Back to the basics

*France Arhar**

BACK TO THE BASICS
Identifying the cause of the crisis and the most effective actions to be taken in order to avert a crisis of such a scope and scale in the future includes answers to the questions such as: how are successful are the supervisors with a mandate to "catch mavericks of financial regulation"; how to strike the right balance between a bank's risk policy and its performance; how to run a bank better and orchestrate all its processes; how to reduce a conflict of interests between contracting parties widely recognised as an acute problem in small economies around the globe, as well as a myriad of other issues that have come out of the woodwork driven by the current crisis.

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Many authors have offered interesting findings in their studies and have come up with proposals and have even voiced concerns about balancing two aspects of financial intermediation in general and the business of credit institutions in particular. Specifically, it is necessary to increase their safety i.e. stability over the long term on the one hand while on the other hand, credit institutions have to improve performance to benefit all stakeholders. The fact is that Slovenia is no exception when it comes to the rising profile of financial intermediation measured by the yardstick of both the real sector as a whole and its integration into the international capital flows. In other words, if this influence is measured by figures, we can see that when the Tolar was introduced as legal tender in the Republic of Slovenia in October 1991, the total assets of the Slovenian banking system accounted for just below one third of the country's GDP. Today, nineteen years later, the combined assets of the Slovenian banks exceed 140 per cent of GDP, even though there is still a wide gap between the figures for Slovenia and the figures achieved by the developed countries in Europe.

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True as it may be that there is a relative underdevelopment of the Slovenian financial market, the current financial crisis has affected all markets and across the globe people are asking the same question: are the existing banking systems "safe and sound" and are they "safe and sound" for depositors above all; could it be that despite a high level of regulation/supervision, credit institutions can still find loopholes in the regulators' net; how are successful are the supervisors with a mandate to "catch mavericks of financial regulation"; how to strike the right balance between a bank's risk policy and its performance; how to run a bank better and orchestrate all its processes; how to reduce a conflict of interests between contracting parties widely recognised as an acute problem in small economies around the globe, as well as a myriad of other issues that have come out of the woodwork driven by the current crisis. It is safe to say that the outbreak of the crisis and the ravages it wreaked has given rise to debates and has assisted in making wake-up calls and pushing forward initiatives addressed to both domestic and foreign markets, as well as to governments, international institutions, and last but not least, individual banks. A common denominator of the reflections about the financial crisis is the cause of the crisis and the actions to be taken in order to avert a crisis of such a scope and scale in the future.

Crisis

First, a couple of words about crisis as a social phenomenon. Since Aristotle to modern times we know/1/ that crisis is understood as a turning point, a judgement and a critical phase, while at the same time it can be that promising and pleasant moment when persuasion is effected when we have proved a truth by means of persuasive arguments.
In Aristotle's Rhetoric we can read that persuasion may come through the hearers when speech stirs their emotions when they are pleased and friendly or when they are paid and hostile. It is towards producing these effects that the circumstances of a shocking critical situation are directed: »kairos-krisis« or right timing for a decision and contemplating the truth. A true orator is the speaker with the power of persuasion to take the individual members of his community to

The combined assets of the Slovenian banks exceed 140 per cent of GDP.

deep understanding of reality, who does not miss such a moment and who finds the persuasive arguments suitable to the case in question. At that point, community members gain insight to grasp the time in which they live and to realise who they are, the insight or revelation described in the last volume of Nicomachen's Ethics. In other words, crisis is a turning point, time in which we live, it is laid out before our eyes, it is a moment when the time is fulfilled (Gospel of Mark 1: 15; The New Testament).

A bank

A bank is a financial intermediary, which collects funds from the general public and makes loans to the specific public. A bank takes up and purses the business of banking on its behalf and for its own account and differs both from a dealer who carries out business activities on his behalf and for account of others and also from a broker whose core business is outing in touch two clients willing to make a deal. Therefore, the very definition of a bank's legal status tells us that a banking firm will be successful in engaging in the business of banking only if it is successful in building trust of all those persons unknown to it and if it is able to maintain that trust over a long period of time. And that's not all. The general public has the status of an »uninformed client«, which means that such clients do not have knowledge necessary to assess all types of risks encountered by a banker that enters into various credit relationships with known clients. At this point we should see what is the most important specific feature of a bank vis-à-vis all other legal and natural persons (individuals): it is the fact that »default of payment« as a category of civil law known since Roman law and recognised in all countries is not granted to a bank, which means that a bank has to honour its obligation right on time, with no delay, since to associate a bank with a delay is construed as illiquidity and illiquidity is the only reason for a bank's demise, failure, liquidation or bankruptcy. We know, on the other hand, that all other corporates have the possibility of »dying by instalments«, they may struggle to stay afloat for years and only banking firms are not allowed to be in a limbo. Moreover, only banking firms are exposed to system risk to a high extent, which means that one bank's financial distress can be contagious and cause big problems to other credit institutions because creditors tend to panic and react irrationally by wanting to have their assets on them and not in the bank. In line with this premise, it means that a banker is indirectly responsible not only for himself but also for others – we may even say that a banker is held

accountable for the financial system should it become wobbly. It is known how many banks failed during two months in Croatia or in the Czech Republic, as well as in a host of other countries between 1995 and 2000. Therefore, by building on this characteristic of a bank, i.e. its status we arrive at a formula that liquidity is a guarantee for stability and reputation of a banking firm.
As we can see in this interpretation, by presuming that a bank has won trust, other fundamental issues for any bank range from, risk and risk analysis to familiar business partners/counterparties and their motives with a long shadow cast by unknown facts expected to come to the fore in the future. It is only time that remains absolute/2/ as opposed to entities and all known and unknown circumstances perceived as being relative, which means that since they keep changing, the risk analysis has to be an on-going task performed as long as there is a business relationship and only when a deal is clinched in the moment when the wills of contractual parties meet.

A Banker

Legal capacity is bestowed upon legal persons by us humans, by our will, awareness and responsibility. To make legal relationships valid and binding, we have to enter into those relationships of our own free will and responsibly, since it is only through a consensus of the will of two parties to the contract that a legally binding agreement is made as a widest possible relationship between contractual parties. How free a market is should be measured by the number of contracts concluded and not by using any other yardstick. As a result, man as a "thinking thing" is the only subject of decision-making and at the same time elevated risk. It is the "breeding ground" of operational risk in financial institutions but also in all other legal persons or corporates. Should we be driven by a desire to contain operational risk to the lowest level practicable, then we have to observe the principle known as the principle of »conscientiousness and fairness« stipulated also in Article 5 of the Code of Obligations (OZ-UPB1) as a prerequisite for entering into all types of agreements, i.e. contracts and not only the contracts to make credit.
It is the principle calling for high standards of fairness, probity and transparency that runs through the fabric of the entire legal system as the underlying covenant /3/. More recent theories give this principle a prominent place among the principles on which states governed by the rule of law are built, and by doing so, this principle gets also a constitutional meaning. By introducing this principle into law, the legislator confirms commitment to achieving appropriate results where a straightforward subsumption could be used to integrate a particular actual state into law and would undoubtedly deliver legal safety, but it would lead to an unjustified legal consequence. At the same time it would mean that legal relationships should be construed in the light of appropriateness or advisability. At the same time, this principle precludes/prevents a trial in the sense of a subjective and discretionary decision-making, since the courts have been thoroughly instructed to apply the principle of consciousness and fairness. Consequently, there have been hot debates between the legal ius strictum and the court ius aequm.
The meaning of the word "consciousness" implies primarily reliability, ability to control/monitor and respect for the counterparty's interests. Consciousness and fairness/probity bring the social and ethical components into law, and exerts loyal behaviour between the contractual parties, as well as mutual trust. Ethics and morality as attributes of business are entering the fibre of the business circles involved in legal transactions. Then again, how effective the principle of consciousness and fairness will be, depends primarily on the purpose and scope of the business deal and quite often on the duration of the business relationship. When taking acting within the framework of the principle that commends ethics and morality, the parties' vested interests must not be neglected and we find ourselves heading toward the theory developed in the constitution and in court cases of proportion of interests. Therefore, when a decision is to be taken, vested interests should be taken into consideration in light of the contractual party's intention.
The obligation to provide an explanation and to inform the contractual party about the execution of the contract is regarded as diligence and fair behaviour, and enables the other party to behave appropriately as well. The obligation to provide information serves, above all, as a tool for preventing damage or loss from occurring, particularly such damage or loss that would threaten integrated/vested interests. It is the diligence in performing tasks assigned and fairness that impose immanent factual constraints on all rights, legal positions and legal norms. At this point we should ask ourselves what is the foundation or a cornerstone of trust or confidence – the attribute all bankers must have if they want to exist. The answer is: fairness or integrity as the cornerstone of public morality. Without personal integrity, there is nothing – there is no professional integrity and vice versa. When we say that someone is a person of high integrity, we pinpoint the person's moral purity and reliability. First and foremost is reliability as one of the main features of

integrity/honesty. Therefore, we can have trust in a person provided that the person has proven to be reliable. A reliable person is "the man of his word", a reliable person does not change and stays the same, does not pretend to be unaware of the actual state of facts when the going gets rough and when he should speak the truth. All over the world, we place our trust only with people of high integrity. We should not forget that the London Stock Exchange, one of the world's oldest stock exchanges going back more than 300 years and established in the 19th century as the institution we know today has the motto «Dictum meum pactum« translated as "My word is my bond" in its Coat of Arms to highlight the importance of the words we say and pledges we make. The latter, in particular, create commitments that should be made only when there is a serious intention to deliver. A person considered reliable is the person who takes personal responsibility for an undertaking, i.e. his/her actions. And should a person fail to demonstrate that he is trustworthy by his doings, then such a person should be held accountable.

If we develop the argument further, a banker that collects funds as primary sources of funding from the non-banking sector, should be regarded as a trustworthy and reliable person, otherwise his hands and feet would be tied and he would not be in a position to do business. The story does not end here. When a banker makes funds collected from depositors available to another group of customers, he is expected to have top qualities – the so-called «duty of excellence«. Georg Simmel, a German philosopher and sociologist voiced concerns in his work » Philosophie des Geldes « (The Philosophy of Money) 4/ saying that an excellent persons is highly individual (individual excellence) and full (total) personality. Individual excellence is a unique combination of awareness of qualitative differences between things as well as between people based on a comparison, while at the same time they proudly reject any comparison whatsoever. Money allows for the movement of property, and property itself becomes an act, an engagement in interactions. Freedom, then, refers intimately to property, the possession of goods or money, allowing for the establishment of ever more relations even though the things created for the sake of money and are value in terms of money only stand in the way of achieving the aforementioned value of excellence in people and things. The ideal of excellence remains indifferent toward any and all quality. The issue of quantity completely withdraws to give way to the presumed self-sufficiency of value provided to a being in which it expresses itself. /We should keep in mind that Simmel wrote The Philosophy of Money at the turn of the 20th century, but the book with its analysis of the wider social implications of economic affairs was re-discovered in a number of European countries and became particularly popular in Germany before 1999
on the eve of the changeover to the euro/5/.

The notion and the meaning of the so-called duty of excellence is demonstrated in modern banking practice also as the theory of »lender liability« spreading from the Anglo-Saxon world into continental Europe and converging with the concept of objective liability/6/. By subjecting lenders to borrower litigation under a variety of legal claims should they fail to treat their lenders fairly, we come across a banker's, i.e. creditor's liability, a concept unknown to the legal doctrine and highly prominent, i.e. intense in the aftermath of market deregulation? The most recent judgements handed down by courts in France and Germany indicate that this type of liability presupposes a top level of professional conduct by all those who work in a bank, which, in turn, simply means that bank employees are held accountable for their conduct from the moment they establish contact with a particular business partner and, above all, he/she has to provide relevant information to the business partner/customer. Furthermore, the credit process in place in every credit institution is duly analysed and the moment when the contractual party learns that a loan has been approved. The fact a loan has been granted is not important only for the borrowers, but also for third parties who share a business interest with the borrower. In the event that the decision to approve the loan is reversed later on or unwinding of the loan is suspended on the grounds that the credit institution has learned about new facts, the Paris court of law still granted the motion filed by a third party claiming that by such an act it suffered damage, since it relied in full on the banker's professional skills and knowledge and on his knowledge of all circumstances. In concrete cases, courts establish also whether the credit institutions have adopted codes of ethics and what they demand from their employees in the course of discharging their tasks and duties and in their contacts with business partners/customers.

The liability of lenders/creditors goes even further in the Anglo-Saxon countries; no tangible business relationship is required being drawn in a contract form, but it shall suffice that a bank has been approached to obtain from it a piece of advice called »duty to advise« and under certain circumstances the bank can be sued in a legal action for damages depending on who the party is in a particular case: commercial parties of equal bargaining strength or a member of the public who is financially distressed through disappointed dealings with a bank. As opposed to commercial parties, natural persons enjoy a special status ex lege, a special type of protection/7./ In this context we should understand also the provisions laid down in the new Directive 2004/39/EC on Markets in Financial Instruments (MiFID Directive) transposed into the Slovenian legislation in the Financial Instruments Market Act enacted in July 2007/.

The situation in Slovenia's banking sector

The current financial and economic crisis also referred to as a crisis of values, has already produced and will continue to have immense consequences also in the future for the Slovenian financial market as well as a result of several features of Slovenia's economy:

- Slovenia is an emerging economy and by definition it needs more vigorous pace of development of »old EU Member States«, which means that it has to make additional investments in a number of areas, if it wishes to catch up with the average GDP per capita enjoyed by the advanced economies within a reasonable period of time. Investments are commonly composed of equity capital and borrowed funds. It is clear that given the current rate of savings, borrowed funds do not suffice to cover all sorts of needs; hence it will be necessary to tap into foreign markets for funding also in the future. As doubts are raised about the workability of global austerity policies, how stable a country is and the ratio between loans made to and deposits gathered from the country's non-banking sector, has become one of the most important criteria applied by foreign creditors. The economies boasting a balanced ratio between deposits accepted and loans made are regarded as highly stable, i.e. in such economies deposits exceed loans. At present, this ratio is over 130 in Slovenia;
- Another problem is the fact that bank borrowings, i.e. its total liabilities/debt are very close to the limit value. In other words, the debt to equity ratio (leverage) is far worse than in the most developed European countries and consequently such enterprises have to strengthen their shareholder equity first and only then there will be new opportunities to obtain bank loans. The issue of finding sources of adequate equity capital remains to be solved, even though conventional wisdom tells us that tapping into foreign markets could be the answer; therefore, it is necessary to lure foreign investors;

Many banks failed in Croatia or in the Czech Republic between 1995 and 2000.

- Numerous undertakings, primarily financial holdings with influence on a number of small and medium-sized enterprises, are currently faced with a major problem associated with bank funding of privatisation (management buy-out) arranged mostly by a few bankers keen to provide assistance and whose role has been crucial for »big privatisation projects«. It is the ease of bank funding and manager appetites that have dealt a blow to the entire Slovenian economy and pain will be still felt by many in the country in the years to come. This may be the right time to raise the issue of »lender liability« in Slovenia and above all to seek answers about corporate governance in certain Slovenian banks, their risk policy, the scope of moral risk assumed, i.e. how to judge hazardous conduct against a backdrop of the principles of good lending and sound liquidity management to be followed by every good banker as the elements of additional professional liability, as well as the issue of identifying a culprit for the dire situation in which some big corporate names are today?
- A peculiarity of Slovenia in the banking sector is also market concentration unrivalled elsewhere in Europe; the fact is that the market share of the five biggest banks in Slovenia is roughly the same as the market share in the medium-sized countries and namely around 60 per cent; what matters more is the fact that between the first and the second largest bank there is an excessive difference in the share of the market, and this gap has existed more or less since the bank rehabilitation process that took place between 1993 and 1997. Such a high market concentration in one banking firm is formally contrary to the Herfindahl-Hirschman Index as a measure of market concentration published by the Bank of Slovenia at the very beginning of its operations and which still remains a "dead letter". Such high concentration in its own right encourages the attitude put at work in practice where such a market player is allowed to assume elevated risk guided by the principle « too big to fail«: should I fail, I will be rescued (bailed-out), since I am too important for the entire market and, after all, such a market structure hinders more normal competition regarded as safer and more successful, and also easier to compare with other similar systems;
- When talking about the efficiency of the banking system during the

last ten years of development between 2000 and 2010, then we should pay due attention to the following systemic milestones generally acknowledged as having had significant influence on the good results posted by the Slovenian banks alongside sound running of the banks:

a) In 2002, having successfully curbed inflation, Slovenia abolished bank capital revaluation adjustment enabling bank profits to jump by approximately 23 per cent;

b) in 2006, the international accounting standards, i.e. International Financial and Reporting Standards were adopted bringing important changes to the bank treatment of provisions accumulated over the last 15 years in accordance with the local accounting standards (Slovenian Accounting Standards) bringing hundreds of millions of euros from bank balance sheets to profit and loss accounts;

c) in 2007 when the local capital market enjoyed a record increase in Europe (it soared by 78 per cent in a year's time), the Slovenia banks implemented the principle of fair value (mark-to-market) for different types of financial assets and once more enjoyed good results in their profit and loss accounts; in addition, in the middle of April 2007, the Bank of Slovenia injected into the banking system approximately 3.5 billion euros held as the investment made by the banking system in the past when Slovenia's central bank was in charge of the country's monetary policy. As a result, the enormous quantity of money in the world market and also the release of the locally held reserves brought to a hike in lending at the rate of 38 per cent per annum granted at symbolic margins that did not take into account credit and other types of risk.

Consequently, by examining and analysing the developments in the local banking market as described above, then we arrive at the conclusion that the results posted by the local banking intermediation have been modest and that on the other hand, due to the piled up risks and bad assets, we are not to expect the results to be achieved by credit institutions operating in the average European market in the near future.

Duty of excellence is demonstrated in modern banking practice as lender liability.

Since the issues of enhancing safety, i.e. stability of credit institutions on the one hand and their profitability on the other have captured the headlines over the past months, a couple of words about the areas that need to be further elaborated:

- An injection of fresh capital is most welcome by any bank's standards, even though, on the other hand, it automatically means that higher profits are expected as bank shareholders have legitimate demands for adequate return on equity currently regarded as hardly competitive given the circumstances. Not only enterprises but also credit institutions are starved for adequate bank capital and if an alternative solution is sought, then the road leads across the border. The ownership structure currently in place in Slovenia shows clearly that there is approximately one third of foreign capital and that a lion's share of funding sources deployed for financing in such banks comes from cross-border markets, as well as the fact that the profits generated in Slovenia are mostly refinanced. If we rephrase the last statement, such financial intermediaries gain particular importance in a crisis and their role is due to gain more importance as the state aid made available to credit institutions is about to dry up. The same applies in the case that Slovenia's sovereign credit rating is downgraded.

- There is another important matter made more acute than usual as the current crisis after its boiling phase continues to simmer: bank manager remuneration. In light of the fact that Europe in general has the so-called universal or commercial banks and not investment or merchant banks as in the USA, there has always been a wide gap between remunerations paid to bankers employed with commercial banks and the other kind of bankers employed with merchant banks which means that the two groups cannot be compared. Since a commercial bank has a portion of its assets in the form of various types of loans, and loans are made as short-term but also as medium- and long-term lending, a bank's remuneration policy should take into account also its risk policy implementation on a medium-term basis since at the beginning, every loan is a prime credit and only as the time goes by, it starts to lose its shine and some are more affected than others. The issue of personal liability should be defined in the same way, since collective liability at the management board and the supervisory board level has been defined even though it is, unfortunately, inefficient. Individual liability would also diminish the impact of »third interested parties« to take one decision or other in their favour, such actions should have been strictly persecuted as criminal offences. When assessing an individual, his »business ethics« should also be examined closely since without high ethical standards it would not be possible to operate successfully in a long run and it is the stamina demonstrated over long term that underpins good results and reputation of a bank and of an individual. Ethics are part of corporate strategy and it may be the company's competitive advantage. It is commonly found in the tiles between companies and it is difficult to copy. Since competition is increasing and becoming fierce, such a competitive advantage could be a key to success. According to some estimates, incorporations in the USA that have adopted the codes of ethics and observe the rules laid down in such codes, generate by as much as 80 per cent higher profits. It is a miraculous weapon/8/ also of the Unicredit Group composed of credit institutions in 23 countries and with more than 160,000 employees has adopted a special document with the title Integrity Charter containing the shared values – a sort of a code of ethics serving to assess individuals vis-à-vis internal and external partners. In addition, every year there is the so-called Charter value day dedicated to debates about ethical and moral norms. Commitment to the implementation of these norms by each and every employee and, in addition, the institute of Ombudsman has been established at each bank's level as well as at the group level to help resolve situations where Integrity Charter values may have been breached.

Instead of a conclusion

All current debate about financial intermediation is largely channelled in two directions: enhanced regulation and supervision coupled with higher capital buffers to make credit institutions a safer place /9/. In my opinion, the foremost and the prevailing concern should be control of operational risk epitomised by man, his consciousness and his knowledge, since all institutions are composed of individuals and the cases we have seen in banking practice point at the importance of each and every individual with his accountability; not only the management board or the supervisory board. I daresaya that due to the phenomenon of liquidity and its potentially lethal effect on a bank's daily status and its survival that it is actually the management board together with other employees, through a higher degree of accountability than seen in any other company where time and default of the debtor offer a life-saving line. This aspect is equally important for every supervision, since loopholes and traps are always hidden in contracts since contracts are and remain » law between parties«; hence, concerns shall be directed during the contract negotiation phase and the analysis of all known risks once the contract is signed, we have to abide by the terms and conditions of the contract, when due, while freedom to re-examine a deal has been sold out by signing the contract or as Goethe's Faust says: "The first is free, the second's slaves are we. The first was so, the second so, and thus the third and fourth are so; and if no first nor second had been there, the third and fourth one would be never."

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