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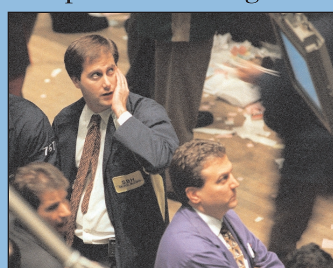
Strengthening Financial Sector Governance in Emerging Markets

Robert E. Litan, Michael Pomerleano, and V. Sundararajan

Policymakers and analysts are still sifting through the wreckage of the Asian financial crisis of 1997 and the subsequent crises in Russia, Turkey, and Argentina to discern key lessons so that similar crises will not recur. Some lessons are by now well understood. Pegged exchange rates can encourage excessive borrowing and expose countries to financial collapse when foreign exchange reserves run dry. Inadequate disclosures by both private companies and public bodies can lead to similar dangers.



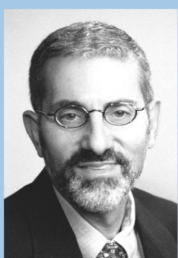
In 1997, Wall Street faltered under the strain of the Asian financial crisis.

Although many factors undoubtedly contributed to these crises, it is now widely recognized that each suffered from a failure in "governance," and in particular a failure in governance in their financial sectors. Accordingly, the World Bank Group, the International Monetary Fund (IMF), and the Brookings Institution devoted their fourth annual Financial Markets and Development Conference, held in New York from April 17-19, 2002, to the subject of financial sector governance in emerging markets. This conference report summarizes some of the highlights of the conference, whose full proceedings will be published as a Brookings book in the fall of 2002.

WHAT IS GOVERNANCE?

In its broadest sense, governance refers to the range of institutions and practices by which authority is exercised. As authors of several of the conference papers pointed out, the term is typically used in a governmental context, and includes the mechanisms for selecting, monitoring, and replacing officials performing governmental duties, as well as those institutions for creating and delivering public goods to citizens.

Governance also has a meaning for the private sector, and specifically for publicly held corporations. Concentrated ownership is one way of solving what has come to be known as the "principal-agent" problem—ensuring that those people running corporations serve the interests of those who own them. Where ownership is more widely dispersed, or where minority shareholders and other stakeholders' interests need to be protected, however, various other institu-



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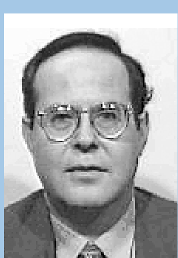

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tions—including disclosure requirements, legal protections of the rights of minority shareholders, fiduciary obligations imposed on officers and directors, market conduct rules, an active corporate takeover market, and incentive contracts for managers—have been developed in advanced economies (especially the United States) to ensure that the interests of corporate agents (managers) are closely aligned with their principals (shareholders), and other stakeholders.

THE FINANCIAL SECTOR

The conference focused specifically on governance in the financial sector in emerging markets, in both public and private contexts. The special emphasis placed on the financial sector reflects the unique character of financial intermediaries, and the added complexity of standard governance problems in the financial sector. For example, questions of transparency, incentive conflicts, and agency conflicts in the corporate sector are compounded by greater opacity, government ownership, and regulation of financial institutions.

Another reason to focus on governance in the financial sector is that the costs can be severe when governance is poor. Every one of the major economic crises in emerging market countries in recent years—in East Asia, Russia, Turkey, Brazil, and Argentina—has been accompanied or has been triggered by a crisis in its financial sector, and in the process, the citizens have suffered deep pain. In the case of Indonesia, which was hit hardest during the Asian financial crisis, the fiscal costs alone of having the government step in to make good on the obligations of the privately held banks exceeded 100 percent of the country's Gross Domestic Product (GDP). Financial crises also typically entail large social and economic costs, which are visited not only on the wealthy who have something to lose, but also throughout the populations of countries where employment opportunities dwindle and wages collapse when GDP drops sharply and currency values plummet.

The costs of financial crises are not the only reasons for being interested in the governance of the financial sector, however. Poor governance is also typically associated with corruption, which not only corrodes the trust individuals have in their private and public institutions, but also acts as a significant deterrent to foreign direct investment (FDI). In one of the empirical papers presented at the conference, Shang-Jin Wei of the IMF and the Brookings Institution estimated that corruption currently imposes the equivalent of a tax on FDI in excess of 20 percent in many emerging market countries. In the process, this "corruption premium" not only depresses the total amount of FDI—in some countries, by more than 50 percent—but also shifts the composition of incoming foreign capital toward bank lending and shorter-term portfolio flows, which makes countries more vulnerable to financial crises if confidence in the economy (or its government) is suddenly shattered.

Daniel Kaufmann from the World Bank explored in his paper the broader linkage between governance in the public and private sectors. Based on extensive empirical studies on various governance indicators, Kaufmann noted that "control of corruption" as an aspect of good governance is strongly and positively correlated with the soundness of financial systems. Kaufmann presented evidence showing that elite financial firms in the private sector often play a strong hand in shaping rules and institutions in the public financial sector, and that the capture of regulators by those they oversee is more widespread in the financial sector than in other regulated sectors. Instead of the conventional policy advice geared at public sector officials, Kaufmann recommends a system-wide approach to reform that focuses on building transparency, improving incentives, and preventing corruption on both the public and private sector sides.

BANKS

Banks are the principal financial intermediary in emerging markets (but less so in developed countries, especially the United States). Banks are funded mainly by depositors, and thus when banks fail, they can adversely affect household wealth, while possibly leading to systemic losses. The developments of new technologies, major industry consolidation, globalization, and deregulation have placed the banking industry at a strategic crossroads.

Gerald Caprio of the World Bank and Ross Levine of the University of Minnesota explained in their paper why banks pose a special governance problem that is different from ordinary corporations. First, banks' activities are more opaque and thus more difficult for shareholders and creditors to monitor. Second, ownership may be dispersed by government regulation (as it is in 41 of the 107 countries for which the authors had data) and thus takeovers may be impeded, directly or through prohibitions on bank ownership by certain kinds of companies. Third, the protection of bank deposits by government deposit insurance programs can undercut incentives for depositors to monitor management. Accordingly, the authors encourage more public reporting of the financial condition of banks, greater entry by foreign banks into emerging markets to enhance competition and bring greater technical expertise to local banking markets, more market discipline to counteract the disincentive effects of deposit insurance (through, for example, subordinated debt requirements), and perhaps enhanced fiduciary obligations imposed on bank managers and directors.

A number of the conference participants were not as confident as Caprio and Levine about the benefits of greater foreign ownership of banking systems, especially in small open economies, where if domestic banks were wiped out, foreign banks would have too ample an opportunity to cherry-pick the best customers and leave much of the country underserved. Several participants also questioned whether concentrated ownership—a frequently mentioned solution to the principal-agent problem for corporations—is appropriate for banks, which can be more easily looted (directly or indirectly, by channeling funds to companies owned by their shareholders).

Meanwhile, despite a wave of privatization around the world in the past two decades, 40 percent of the world's population still resides in countries where most bank assets are controlled by state-owned institutions. State-owned banks pose special governance problems. Government ownership thwarts competitive forces, limits the effectiveness of government supervision in the financial sector, and tends to increase the opacity of banks' operations. Governments can use their state-owned institutions to support excessive government spending and to favor borrowers that are less than creditworthy. In addition, governments

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often operate their institutions, or the regulatory processes that govern them, in ways that discourage the development of vibrant private sector competitors. For all of these reasons, there was support voiced at the conference for efforts by governments that continue to own banks to privatize them.

The experiences of the Hong Kong Monetary Authority (HKMA) and the Monetary Authority of Singapore (MAS) are instructive and offer possible remedies to address governance problems in the financial sector. For instance, enhancing competition by opening the financial sector to foreign investment decreases the reliance on family or conglomerate relationships. Legal and bankruptcy frameworks are critical, also, to put the right incentives in place for a competitive financial sector. To promote transparency and independent audits of financial institutions, HKMA issued a guideline in May 2000 requiring that the board of each bank establish an audit committee made up of non-executive directors, the majority of whom should be independent; the members would have written terms of reference specifying their authorities and duties.

MAS takes another approach to fostering governance of banks: it requires banks to separate financial and non-financial businesses and to change their audit firms every five years.

INVESTMENT COMPANIES

Collective investment schemes—which enable investors to own proportionate shares of a pool of financial assets—have become increasingly important financial institutions in developed countries. The governance structures of these institutions vary widely. Corporate style mutual funds, found mostly in the United States and a few emerging markets, dominate in terms of value of assets. Contractual and trust type structures dominate in terms of the number of funds, and are found mostly in countries where joint stock company laws do not permit firms to continuously issue and redeem their own shares, or where liquid markets to manage open-ended schemes may not be well developed.

Sally Buxton and Mark St. Giles of Cadogan Financial argue in their paper, however, that the governance structure is irrelevant for the conduct and performance of collective investment funds. The key to their sound performance lies in effective market discipline underpinned by strong disclosure. Yet the authors report that it is difficult in many emerging markets even to locate a list of what investment funds are available. Accordingly, they recommend that emerging markets set and enforce disclosure standards for investment vehicles (including requiring that net asset values be published regularly), while educating the public—through the media—about their risks and rewards.

Asset management companies, or AMCs, a very specialized type of investment vehicle, were created by East Asian governments to hold and ultimately sell troubled assets (often loans) that were formerly on the books of weak or insolvent financial institutions. In countries where banking problems have been severe, AMCs have become major financial institutions in their own right. For example, the Indonesian Bank Restructuring Agency controls 70 percent of the financial sector assets in Indonesia. The conference participants discussed the experiences of the AMCs created following the Asian financial crisis. They generally agreed that many of these institutions faced conflicting objectives; their responsibilities were poorly defined; and oversight committees were not sufficiently separated from management. Looking ahead, possible solutions are to explicitly articulate the missions of the AMCs; to ensure that AMCs are overseen by independent and informed oversight committees: and to create independent operating boards with authority to manage AMC activities.

PENSION FUNDS

As the population of the world ages, pension funds—both public and private—assume greater importance, both for the individuals covered and for the development of the financial systems to which the funds belong. At this point in time, according to data provided in a paper presented by Gregorio Impavido of the World Bank, almost half of the world's labor force is covered by mandatory, publicly managed, defined benefit pension plans that are funded on a "pay as you go" basis. Another 32 percent is covered by partially funded public pension systems. Just 10-15 percent of the world's labor force is covered by public or private defined contribution pension funds.

The governance of pension funds is critically important, since the quality and performance of fund management can determine the income flows to which retirees are entitled, as well as the level of government funding of any shortfall between what the plans may promise (if they are defined benefit) and what they are capable of delivering. Impavido provides evidence of poor performance by many publicly managed pension systems, and demonstrates that this poor performance is highly correlated with measures of (poor) governance, including government-imposed restrictions on investments and the absence of pension board authority to govern investment decisions. Impavido recommends that public pension programs be given a clear mandate—to maximize the returns for retirees—and not be assigned collateral social objectives; that the boards be insulated, to the maximum extent possible, from political influence; that the members of the board meet rigorous qualifications for serving and that they understand and avoid any conflicts of interest when administering these plans; and that the performance of the plans be disclosed regularly so that boards can be held accountable to beneficiaries.

THE ROLE OF CAPITAL MARKETS

Achieving good corporate governance generally has been more challenging for emerging market countries than for advanced economies (notwithstanding the failure of Enron and other companies in the United States) for a number of reasons: corporate ownership in emerging market economies tends to be highly concentrated, often in a few families, with only limited ownership by minority shareholders; takeover markets are thin or nonexistent; and judicial enforcement through formal government sanctions or class action suits also are widely used or available. Various ideas for improving corporate governance in these circumstances were suggested at the conference.

One improvement might be a requirement that certain kinds of corporate transactions, especially those involving controlling shareholders, be approved by a majority of the minority shareholders. Another participant suggested having specialized courts with

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expertise in corporate law. Some participants thought high listing standards on exchanges, such as those now used in Germany and Brazil, would strengthen corporate governance, but others questioned whether there was enough of a demand by companies to satisfy those standards. Another possibility would be to limit investments of pension funds in local companies only to those firms that meet certain minimum, but high, corporate governance standards. The participants broadly endorsed the implementation of internationally endorsed best practice guidelines for corporate governance, especially enforcement of rules on disclosure.

An important lesson that emerged from the papers and from comparison of various countries' experiences was that no single change in capital markets promises to be a "silver bullet" solution to the governance challenge. Furthermore, reform must be tailored to the specific institutions and culture of individual countries. For example, the fear of hostile takeover, which is a strong disciplinary force in U.S. markets, relies on a rather well developed high-yield bond market, that has been a source of funding for acquiring firms. However, since takeovers are not prevalent in emerging markets and other developed economies, this blunt instrument of corporate governance that wrenches out corporate inefficiencies in advanced economies is simply not relevant in emerging markets.

One area of continuing controversy in academic circles about corporate governance is whether Anglo-American common law, where rules are developed over time on a case-by-case basis, does a better or worse job in fostering the development of financial markets than European "civil law," where the rules are set forth in statutes and tend to be less changeable over time. In examining this controversy, Cally Jordan and Mike Lubrano of the World Bank Group agree that legal traditions and systems fundamentally shape the feasibility of various corporate governance mechanisms. But as they highlight in their paper, the debate over the superiority of Anglo-American or European civil law obscures the very important governance role played by private rules, whether by contract, often underpinned by voluntary codes of conduct and thus adopted *ex ante*, or through *ex post* enforcement through contractual dispute resolution, including arbitration, or through market discipline. Drawing on recently published work, Jordan and Lubrano make the case that private law has been especially important in the development of markets for derivatives instruments.

PUBLIC SECTOR GOVERNANCE

Finally, given the economic importance of the financial sector and the dangers when it functions poorly, it is not surprising that governments in both developed and emerging market countries alike take a keen interest in regulating and supervising financial institutions and markets. Jeff Carmichael, chairman of the Australian Prudential Regulatory Authority, points out in his paper that the public sector has a close and complex relationship with the financial sector in most economies, often playing several roles simultaneously: the regulator of financial institutions; an owner of financial institutions; a market participant; a fiduciary agent; and sometimes an agent that directly intervenes in the operations of the market. Carmichael outlines a number of principles for effective public sector regulation and oversight. These principles were further analyzed in both "normal" times and "crisis" periods in another paper presented by Udaibir Das and Marc Quintyn of the International Monetary Fund.

First, perhaps the most important financial public sector governance principle is to assure the independence of financial regulators, matched by appropriate accountability arrangements. Regulators must be protected against both capricious dismissal and damage suits for performing their regulatory duties.

Second, government agencies (whether financial or not) should have transparent objectives and operational processes, both supported by adequate reporting to the public.

Third, arrangements should be in place to ensure the integrity of the regulatory agency. For example, it is useful to maintain and enforce codes of conduct to govern the staff of regulatory bodies, including a mechanism for judicial review of agency decisions. Carmichael also reinforced the importance of preventing corruption from infecting public oversight of financial institutions and markets.

Das and Quintyn emphasized how in situations of financial distress and crisis, incentives for good corporate governance can be distorted, and the scope of regulatory governance has to be reinforced through new institutional structures with enhanced transparency and greater accountability.

The IMF and World Bank are working jointly to assess adherence to financial sector standards, as part of a broader assessment of stability and development needs in the Financial Sector Assessment Program (FSAP). Since the inception of the FSAP in 1999, nearly eighty countries have participated or agreed to participate in the program. FSAPs typically have assessed country practices against various internationally accepted standards in supervision, transparency, and market infrastructure (in particular, the IMF Code of Good Practices on Transparency in Monetary and Financial Policies), as well as international standards for the supervision of banks, securities firms, insurance companies and payments systems. As stressed in the Carmichael and Das-Quintyn papers, these standards give primary emphasis to the importance of independence of regulatory agencies from political influence as a threshold indicator of good public sector governance.

Based on their review of the findings of the FSAPs, Das and Quintyn reported that securities regulators score higher on the scale of governance than the regulators of other sectors. They are immediately followed by banking regulators, who score as high as they do because in many countries banking supervision is carried out by the nation's central bank, which is more than likely to be strong institutionally, adequately funded, and independent of much of the rest of the government. Insurance regulators face the greatest challenges in adhering to international standards.

Another key indicator of good public sector governance is the degree of transparency of the regulatory objectives and operations, including their relationships with other agencies. By this measure, the FSAP process reveals that developing countries as a whole, including transition economies, lag behind advanced countries. On the positive side, however,

Robert E. Litan, Michael Pomerleano, and V. Sundararajan are the authors of *Building the Pillars of Financial Sector Governance: The Roles of the Private and Public Sectors*, forthcoming from the Brookings Institution Press.

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even in developing countries, banking and payments systems supervisors—again, often central banks—score reasonably high.

SUMMARY AND CONCLUSIONS

Public and private financial sector governance cannot be addressed in isolation without considering the institutional setting. Differences across countries in the degree of rule of law, competition, and in the effectiveness of the takeover market shape the effectiveness of governance measures. With respect to governance in the financial sector in particular, policymakers must recognize and take account of the unique institutional and legal climates in various countries. For example, it is useless to apply threat of litigation as an instrument for enforcing governance in a country that lacks the legal institutions or cultural tradition for lawsuits. Likewise, policymakers cannot expect that market discipline or 'reputation risk' will rein in financial managers when the necessary mechanisms to ensure markets work well—transparency, ability to exit and enter markets, and competition—are lacking.

As a result, there is no single, universally applicable remedy to governance challenges in the financial sector. Instead, the collection of papers and discussion at the conference suggest a two-pronged effort, with each element reinforcing the other: one that works to strengthen regulatory oversight on the one hand, while enhancing informational transparency, contestability of markets, foreign access, shareholder participation—in effect, greasing the wheels of the market—on the other.

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