IQRA National University Peshawar

Assignment

Title

ESSENTIALS of Corporate Governance
Sanjay Anand

Course

Corporate Governance

Submitted to

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Assignments:

Have to study any two books from the given list and submit summery of two book one before midterm exam and second before final term exam. (*four books are provided in soft form to all students)*

Books list:

1: Corporate Social Responsibility *The Good, the Bad and the Ugly*
Subhabrata Bobby Banerjee
Professor of Management and Associate Dean of Research,
College of Business, University of Western Sydney, Australia

2: Corporate Governance in Banking *A Global Perspective*
Edited by
Benton E. Gup
University of Alabama, USA

3: ESSENTIALS of Corporate Governance
Sanjay Anand

4: Corporate Governance
Fifth Edition
Robert A. G. Monks and Nell Minow

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Chapter 1

Corporations

Corporate Structure

It is sometimes helpful to think about corporations as imaginary People. In many ways they do have the same rights and powers that the average citizen does; they are able to open bank accounts, file taxes, Make purchases, and own property. Unlike no incorporated businesses that do these things under their company name, the corporation's assets are not directly owned by the company owner or partners. Specifically, when a no incorporated Business purchases property, the deed is held by the company owner. However, when a corporation does the same, the deed is held by the Corporation itself.

Corporate Organization

Corporations are owned by stockholders who purchase shares and therefore own a percentage of the sum of the corporation's assets. The stockholders elect a board of directors to represent their interests and govern the running of the corporation. The directors then appoint an executive to oversee the operations of the corporation. It is the role of the directors to govern the actions of the executive and Ensure.

Corporate Ownership

Shareholders are the legal owners of the corporation. However, this concept of ownership carries roles and rights different from those commonly associated with the concept of private ownership.

Benefits of Incorporating

Although companies all have unique reasons for seeking incorporation, one of the principal advantages is that assets of the corporation are not linked to the assets of the owners (shareholders). Because the corporation is its own entity under the law,

Purpose of Corporations

There are many debates about the purpose of the corporation. These debates include questions about whose needs the corporation is designed to fulfill. Some believe that the corporation's sole purpose is to meet the needs of the shareholders, and that in doing so, everyone will be better off. Milton Friedman, author and economist, was one of the most notable proponents of this belief.

The Government, the Economy, and the Corporation

In this chapter we discuss the possibility that corporations have an obligation to meet the needs of the economy in addition to those of the shareholder. Whether or not corporations agree that they have such a duty, the government, in most instances, insists on it. Government intervention and regulation of corporate activity is geared toward protecting the interests of the economy and the society while at the same time fostering successful business efforts.

Corporations and Ethics

That corporations have some level of ethical responsibility is almost universally agreed. Dissent and debate occur when the level of ethicalresponsibility is discussed, with some factions believing that corporate obligations do not extend past increasing share values and others arguing that as legal entities, fictional or not, corporations have ethical responsibilities.

Capital Structure

Corporations must have systems in place by which they finance themselves. In most instances these systems include some combination of equity sales, equity options, bonds, and loans. The exact formula used is different for each corporation, and every entity works to discover the optimal combination that provides the greatest stock value and lowest cost.

Governance

This book is dedicated to explaining and illustrating the importance of good Corporate Governance and the concepts that this entails. One of the first distinctions that must be made, however, is the distinction between the value-based definition of Corporate Governance and the practical-based one.

Chapter 2

History

The Early Years

One of the earliest of the modern corporations was the East India Trading Company, created at the turn of the sixteenth century. This corporation, like most others at the time, was created by the British Crown.
In fact, in the early years, the United States was partially run by corporations, when some individual states were ruled by companies, such as the Massachusetts Bay Company. After gaining its independence, the United States chartered corporations at the state level, but these companies were small and did not have the same autonomy as today's corporations.3

Types of Corporate Structure

The corporations of all countries do not all working the same way. Having evolved indifferent economic and political climates, corporate structure varies around the globe. Although we discuss this concept in greater detail later, for now it is important to understand that the corporate structures we see in the United States are not the models seen elsewhere. One of the most striking distinctions is that between the United States and Germany. In Germany, financial institutions are frequently large stakeholders in corporations, something that would not be seen in the U.S. model.

Historical Legal Landmarks

The history of Corporate America is marked by several significant historical landmarks. These events have helped to create the unique corporate structure found in the U.S. economy, just as events unique to other countries have shaped their corporate structures.

Securities and Exchange Commission

The SEC was established through the enactment of the Securities Exchange Act of 1934, following the crash of the U.S. market. The principal goal of the SEC is to regulate corporate activities through policy development, compliance guidance,

and information gathering. To facilitate its mandate of protecting shareholders from corporate corruption and false accounting practices, the SEC requires that all publicly traded companies regularly disclose specified information through the submission of various forms.

Corporate Scandals of the 1990s and 2000s

At the turn of the millennium, the public witnessed several major corporations' fall to corruption. The court cases, bankruptcy filings, and civil suits that followed were the results of various instances of insider trading, inaccurate financial reporting practices, and other corrupt activities.

Sarbanes-Oxley Act

Following several notable examples of corrupt accounting practices in the 1990s, the U.S. government drafted and passed SOX in 2002. The purpose of this act is to protect investors and establish accounting guidelines to create greater transparency in the financial reporting practices of corporations.

Chapter 3

Shareholders

Ownership and Responsibility

As the legal owners of the corporation, shareholders are entitled to secure their investment by participating in the company's activities, although their involvement is limited. Shareholders are not involved in the operations of the corporation, except through their election of the board of directors and voting on proposals. Additionally, those who own stock, although technically they have purchased a portion of the company's assets, have no access to those assets. Instead, the real value of the stocks is limited to dividend payment, share resell, and potential asset value division at the dissolution of the corporation.

Board Elections

Shareholders vote to elect board members who they believe will take good care of their investment in the corporation. In most situations the shareholders vote on potential candidates who were nominated and screened by the sitting board members.

Proposal Submission and Voting

Throughout the fiscal year, shareholders are able to submit proposals to Help direct the corporation in the direction that they deem fit. These Proposals, as well as those put forward by the board, are voted on by the Body of shareholders.

Duty of Loyalty and Duty of Care

To protect shareholder interests, the board is assigned two fiduciary duties: the duty of loyalty and the duty of care. The extent to which the board meets these duties can be taken as a measure of its effectiveness.

Duty of loyalty. In keeping with the duty of loyalty, the board and its members are required to act on behalf of shareholder and company interests, rather than their own.

Duty of care. This duty requires that company directors make reasonable efforts to care for the company's interests.

Shareholder Meetings

Shareholder meetings are held to provide shareholders with a forum in which to gain information and cast votes. Although designed to ensure that investors are able to actively protect their investments, As the legal owners, shareholders are a fundamental part of the corporate structure. Their position as owners is unique, however, in that they do not hold legal or financial responsibility over the corporation's actions or events. Shareholders also have limited avenues available to them for monitoring corporate activity and being involved in the company's decisions.

Chapter 4

Board of Directors

Structure

No one-board profile will fit the needs of each and every corporation. Instead, the perfect composition of the board will be a direct reflection of the corporation's unique structure and needs.
In most cases, the specific framework for the board's structure will be established by the corporation's bylaws. In some circumstances, however, the structure of the board will have to change in order to accommodate new developments within the corporation, such as growth or merger.

Responsibility of Selecting the CEO

One role of the board of directors is to select a CEO to fill the position as it becomes available. The strategy for choosing a new CEO consists of careful evaluation of the candidates, establishment of an effective recruiting strategy, strong communication and support regarding the change, and careful evaluation of the new CEO.

Evaluating the Candidates

In theory, candidates for the CEO position can come from anywhere. In reality, however, these candidates are likely to come either from within the company's own management team or from that of a close competitor. It is very rare for a CEO to come from an unrelated industry or a no management position.

Effective Recruiting

The successful appointment of a CEO is dependent on the corporation's ability to secure the prospect's interest. Just as the board considers several factors when selecting the CEO, the candidate must consider various issues when deciding whether to accept the position.
A prospective CEO will evaluate the company in terms of:

Its history and reputation. The candidate will want to ensure that his or her professional reputation will be helped, not harmed, by accepting the position.
The compensation package. The compensation package includes not only salary, but also bonuses, stock options, and benefits. One
argument in favor of high CEO compensation rates is that the remuneration is a key factor in recruiting quality CEOs.
The relationship of the executive and the board. A board that is too overbearing and infringes on the executive's ability to run the corporation will not impress a CEO.

Responsibility of Selecting the Executive

One of the principal responsibilities of the board of directors is the selection and appointment of executive members, including the CEO. Intricately related to this function is the board's role of governing the executive and taking action when the executives' activities do not coincide with the best interests of the corporation and its shareholders.

Independent Outside Directors

An effective board must contain a balanced mix of members both from within the company and from outside. This ensures that the board remains independent and objective, thereby maximizing its ability to make decisions that are in the best interests of the corporation.

Elections

Generally speaking, it is impossible for shareholders to run a corporation directly. In most cases, the body of people who own a corporation's stock is very large. There is also the fact that purchasing stock does not mean that the shareholder has any business expertise or the ability to run a company.

Compensation

The members of the board of directors are compensated by the company. There are several possible methods for compensation, and the specific packages are usually a combination of salary, stock options, and bonuses.
Director salary.

The salary level of directors is determined by the compensation committee and varies widely between corporations. In situations where these salaries are apparently lofty, justification arguments appeal to competition for quality members and the importance of a strong board.
Stock options.
It is important that members of the board be compensated, in part, with packages that include company shares. The simple logic behind this requirement is that doing so encourages the directors to behave in the best interests of the shareholder, by making those interests their own.
Restricted stock.
Restricted stock has limited trade provisions associated with it. These restrictions serve to prevent insider trading and other stock-related scandals.

Reprisal

Just as shareholders are able to elect directors to the board, they are also expected to be able to remove them. Should the stockholders have a substantiated belief that a director is not behaving appropriately or is violating any fiduciary duties, they are able to petition for the director's dismissal, enact a class action suit, or seek a legal injunction.

Additional Committees

To help facilitate its ability to monitor the corporation's activities, the board of directors often is subdivided into smaller committees.

Chapter 5

CEO and Chairperson

Role of the Chairperson

The chairperson is responsible for the organization and activities of the board of directors. This position is elected by the shareholders at the annual shareholder meeting.
In terms of desirable characteristics, an ideal chairperson will exhibit exemplary ethical and moral standards. He or she will also possess strong leadership skills and have the ability to manage the board effectively.
Finally, it is also desirable that the chairperson have the ability to facilitate strong communication and mutually respectful relationships between the board and the executive and the board and the shareholders.

Expectations of the CEO

A corporation's CEO is appointed by the board to spearhead the management of the corporation. In selecting a newCEOor evaluating a current one, the board will look for several key characteristics that are generally considered desirable:
_ Strong performance record.
When selecting a CEO, the board will look at the candidate's performance record in his or her current and past positions.

Executive Compensation

As misdeeds of executives become increasingly publicized, shareholder interest in executive compensation grows. No longer do shareholders have blind faith in the decisions of the board; instead they require documentation and evidence. Of particular concern are situations in which compensation decisions are compromised by conflicts of interest. As a result, many corporations are disclosing more information than in the past to reassure shareholders.

Board–Management Relationship

Several scenarios can play out between the executive and the board. Walking into boardrooms across the United States would provide a glimpse at all of these, as they are all present in some capacity in today's
corporate culture. The models for board–management relationships include the board as governor, the board as ''yes-sayer,'' and the board as meddler.

CEO Succession Planning, Selection, and Performance

We discussed the concept of entrenchment earlier in the book. Like boards, CEOs can also become entrenched well past the time during which they are successful in running the company. When CEOs have outlived their usefulness, it is said that their term has run too long

Chapter 6

Good Corporate Governance: An Introduction

Definition of Corporate Governance

A truly complete and representative definition of Corporate Governance can be elusive; many have struggled to find the words and phrasing that will capture everything that Corporate Governance is. Corporate Governance is a broad and complex concept that incorporates almost every aspect of corporate life.

Basics of Corporate Governance

One of the most fundamental components of good Corporate Governance is the establishment of an effective company hierarchy. This means that the shareholders, board members, and executive, as well as their respective relationships, must all be organized in a manner consistent with Corporate Governance principles.

Theories of Corporate Governance

In 1932, Adolf Berle and Gardiner Means co-wrote The Modern Corporation and Private Property.[1] In this book they argued that the separation of ownership from management within corporations created managerial economy in which the interests of the managers could supersede those of the shareholders.

Agency Theory

A concept strongly related to Corporate Governance, ‘‘agency theory’’ refers to the best practice for organizing the relationship between the principal and the agent. This theory was a large component of Berle and Mean’s discussion of Corporate Governance. In their context,

Models of Corporate Governance

As the concept of Corporate Governance has evolved and the importance of good Corporate Governance principles has become increasingly accepted, several models have emerged. Each of these models has been implemented in various markets and with various degrees of success. All have their unique benefits and challenges.

Principles of Corporate Governance

Corporate Governance is a concept that is best served by focusing on the end rather than the means. Put another way, because the rules and guidelines of Corporate Governance are always changing and evolving, it is important that we do not get so caught up in the procedures that we forget the goal.

Chapter 7

Signs of Trouble

Indicators Relating to the Board

In evaluating the strength of a company, one of the first places to look is the board of directors. This recommendation is based on the fact that without a strong board, the company cannot hope to have a strong practice of good governance.

Indicators Relating to the Executive

Although it is unfair to paint all executives with the brush of scandal, it is true that most of the turn-of-the-millennium scandals were centered on the actions of executive members, particularly CEOs. Because the executive is the group in charge of the corporation's operations, profiles of its members can offer insight into the overall financial and structural health of the corporation.

Indicators Relating to Shareholders

Shareholders are the owners of a corporation. As such, the behaviors of the shareholders are very tightly integrated with the company's success. Although they are not able to make direct decisions about the corporation's daily affairs, shareholders are able to set the overall tone for the corporation.

Chapter 8

Changes Made Through Corporate Governance

Whistle-blower Procedures

The term ‘‘whistle-blowing’’ applies to the actions of any company member who exposes a perceived wrongdoing that is occurring within the organization.

Importance of the Whistle-blower

Two types of impressions surround whistle-blowing. On one hand, there are those who value whistle-blowers and view them as brave people trying to combat corruption and unethical behavior. On the other hand, some still view whistle-blowers with contempt and consider them traitors to their company or colleagues.

Protecting the Rights of Whistle-blowers

The rights of whistle-blowers within a company publicly traded on a U.S. market are protected by the Sarbanes-Oxley (SOX) Act. The provisions of the act protect whistle-blowers by outlining actions that would be considered prohibited retribution. This section of the act also provides protection by offering specific penalties that may be implemented should whistle-blowers suffer fromretribution as a direct result of their reporting activities.

Establishing Policies

SOXrequires that corporations establish theirown internal policies and procedures to facilitate whistle-blowing activities and prevent unfair retribution. Key components of these policies will be the inclusion of privacy provisions, processes for reporting, strategies for investigating reports, and, in some cases, the establishment of a compliance officer or committee.

Duties of the Whistle-blower

Just as the company should be governed by whistle-blowing policies, so should whistle-blowers follow a code of conduct.

Educating Employees

In order for a whistle-blowing policy to be effective, company members must be informed and educated about the rights and duties of whistle-blowers. An employee education program could include the publishing of a formal written code and ethics workshops that discuss whistle-blowing. Most important, employees need to understand the avenues available to them should they have a concern to report.

Code of Ethics

The establishment of a code of ethics is not a new concept within companies. It is something that most corporations implemented at their inception but have not revisited in several years. A corporation's code of ethics should establish guidelines and expectations for company members so that they can understand what issues they must consider in their actions and decisions.

Principles of the Code

In general, a corporation's code of ethics will include guidelines for dealing with financial records, expectations for compliance with laws and regulations, procedures for identifying and eliminating conflicts of interest, an explanation of the company's code of confidentiality and its enforcement, and strategies for the promotion of an ethical environment within the company.

Setting an Example

The establishment of an ethical environment within a corporation requires the cooperation of all company members. However, it is particularly important that members of management set the example for all other employee

Code Establishment

The shape that a corporation's code of ethics will take varies depending on the unique structure of the company. Where one company may find that one code will suffice, others may choose to establish separate codes for various regions and levels within the company. For example, within an international corporation, the multiple-code strategy for the various geographic regions may be the best choice.

Performance Evaluations

Board and executive evaluation is vital to a healthy corporation. When a corporation is running properly, the board of directors should be able to identify problems among its own members as well as those of the executive. After identifying these issues, the board takes measures to remove or rectify the problem, thus ensuring that the corporate body remains as productive and effective as possible.

Compensation Packages

Along with evaluation, compensation packages of the board and executive are also a major issue in Corporate Governance. While the compensation levels for board members are outlined in the corporation's bylaws, the board has the power to make amendments.

Director Elections

Looking back at our discussion of board entrenchment and its dangers, we can see that board elections are a vital component of a healthy Corporate Governance structure. The board is the shareholder representative,
and must therefore truly represent the wishes of the majority of shareholders.

Chapter 9

Regulations and Strategies for Corporate Governance

Sarbanes-Oxley Act

The Sarbanes-Oxley (SOX) Act was passed in 2002 with the intention of protecting investors and establishing guidelines for financial reporting.
Investors and other interested parties use a corporation's financial records and related information as a method of evaluating the corporation.

Securities and Exchange Commission

Regulations for Shareholder Proposals

We have consistently discussed the importance of shareholder activity throughout this book, but it is worth mentioning again. Shareholders, as the owners of corporations, have a material interest in the company's events and status, and should therefore be able and willing to participate actively.

Organization for Economic Co-Operation and Development

The Organization for Economic Co-operation and Development (OECD) offers membership for 30 countries and has a relationship with over 70 others. Although perhaps best known for its work with public corporations and Corporate Governance, the OECD is involved with other economic areas, including nongovernmental organizations.

Cadbury Report

The Cadbury Commission's Financial Aspects of Corporate Governance,
more commonly known as the Cadbury Report, has made a strong contribution to the process of Corporate Governance in the United Kingdomand has influenced CorporateGovernance efforts around the world.

Balanced Scorecard

The Balanced Scorecard strategy was developed to simplify and streamline the way in which a corporate executive thinks about the corporation's priorities and obligations. In a sense, the Scorecard is meant to provide the big-picture approach so that the executive does not lose sight of the goals when focusing on the details.

Good Corporate Governance Components

Corporations with strong histories of good Corporate Governance take time to build; they do not happen overnight. One of the key factors in establishing good Corporate Governance practices within a company is to prepare. The committee or individual in charge of establishing such practices needs to be educated about important issues and concepts; also, the committee or person must take an inventory of the company.

Chapter 10

International Corporate Governance

Corporations Around the World

A common theme discussed throughout this book is the concept of corporations as entities that have evolved from the unique circumstances of their countries. Earlier chapters have illustrated that political, social, and economic landscapes work together with historical events to shape the corporate structures that are apparent within each region.

International Corporations

In the past, international corporations have benefited from diminished regulations, the ability to operate in regions with fewer laws, and a perception of unlimited freedom. Additionally, inexpensive labor and lower tax rates have been large factors in drawing company activities away from developed countries and into emerging nations.

Global Investors

Domestic corporations often seek to expand their capital base by selling shares to foreign shareholders. When a corporation of one nation lists itself on the market of another nation, it is referred to as a foreign issuer.

Global Corporate Governance Forum

As an initiative between the OECD and the World Bank, the Global Corporate Governance Forum seeks to facilitate discussion of international
Corporate Governance frameworks. This forum's general mission also includes efforts to educate the international market on the importance of good Corporate Governance and the benefits that compliance can offer.

Chapter 11

Corporate Governance in Emerging Markets:

Asia and Latin America

Asia

A common theme in the profiles of many Asian corporations is that they are family owned. In fact, family-owned firms represent anywhere from one-half to two-thirds of the publicly traded corporations of any given Asian country.
A second corporate feature of Asian companies is the pyramid structure, where one parent company operates partnerships and ownerships of several subsidiaries. The culminating effect of family ownerships and complex webs of subsidiaries is a system in which transparency is difficult to foster and nonfamily investors are not afforded the same privileges as the family.

Latin America

As the economies of Latin American countries become increasingly privatized, the importance of good Corporate Governance practices is an emerging concern. Generally speaking, the bulk of capital activity in these regions has fallen on the public sector and small companies within the private sector.

Chapter 12

Not-for-Profit Organizations

Nonprofit and For-Profit Corporations

Intuitively when we think of corporations, we think of those with stocks that are traded on public markets, and are owned by shareholders. Although this is one formof corporation, there is another: the not-for-profit corporation.

Stakeholders, Not Shareholders

Not-for-profit corporations are not traded on markets and are prohibited from paying dividends. Although they do not have shareholders, not-for-profit corporations and their boards do have obligations to stakeholders.
In terms of the not-for-profit corporate structure, the stakeholders are the same as those in for-profit organizations, with the exclusion of the shareholder. These stakeholders include employees, volunteers, no shareholder investors, and others who offer financial and nonfinancial
support.

Underlying Principles

The motivations of establishing good Corporate Governance practices within not-for-profit corporations are different from those of their for-profit counterparts. Not-for-profits are not striving to improve trust and relationships with stockholders, but are instead working to improve trust and relationships with philanthropic investors. As a result of these differences, the goals of Corporate Governance will vary between the two classes of corporation, but the underlying principles remain the same.

Improved Security of Accounting Practices

A large component of improving Corporate Governance policies in for-profit corporations is the establishment of secure accounting practices to protect the funds of investors and prevent the corporation from falling to bankruptcy due to scandal. Improved security of accounting practices is equally important in not-for-

profit corporations that are also charged with protecting the funds of others. In this case, the money belongs in part to those who have donated it and in part to those whom the services are meant to help.

Benefits of Good Corporate Governance for Not-for-Profit Corporations

Not-for-profit corporations that establish strong Corporate Governance practices will enjoy many benefits, not only in terms of their public image, but in the efficacy with which their organizations are run. It is easy to forget, as we discuss Corporate Governance, that it is not simply a hoop through which corporations jump to appease investors; it is a system of best practices that improve the functioning of the corporations themselves.

Ideal Not-for-Profit Corporate Governance Profile

A not-for-profit corporation can facilitate its own success by taking an inventory of its strengths and weaknesses and building its Corporate Governance policies to improve all areas of operation.

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Corporate Governance in Banking *A Global Perspective*
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Chapter 1.

Corporate governance, bank regulation and activity expansion in the United States

HISTORICAL PERSPECTIVE

In the early days of banking, the overlap between corporate governance and bank regulation was readily observable. In eighteenth-century England, governments delegated public functions to a variety of private firms, including banks, through the issue of a corporate charter. The charter was a grant by a sovereign authority to run a specific business or to trade in a specified area for a specified number of years (Berle and Means, 1940: 128 ff.; Hurst, 1973: 152 ff.)

DEREGULATION EFFECTS

The last half-century, and particularly, the last 25 years has seen a withdrawal from both the additional regulation that had been established from 1933 to 1956 and from earlier restrictions that had characterized American banking
almost from its origin. The influence of the regulatory agencies might, in these circumstances, have been expected to recede and the influence of corporate governance to advance. To some extent, this has been the case, but there have also been some counter-intuitive developments.

Large Complex Banking Organizations

Deregulation, along with global expansion, has generated a merger and acquisition movement that has produced a relatively few very 'large, complex banking organizations' (LCBOs) that control a substantial proportion of industry assets (DeFerrari and Palmer, 2001: 47–57;

Capital Requirements

As regulatory concerns about disruption caused by small bank failure have diminished, concerns about failure of large banking organizations, and particularly LCBOs has grown. With their increasing economic and financial importance, the systemic threat they present is a focal point of regulatory concerns.8 One result has been a more sophisticated approach to capital requirements.

Supervision

With restraints on activities and branching lifted, and banks no longer sheltered from competition, managers are, of necessity, concerned with new profitable opportunities, including mergers and acquisitions. In the new environment, Federal regulators have revised their supervisory approach. Banking companies have typically been examined or inspected once a year. Loans portfolios were valued, and assessments were made as to the bank's capital adequacy, assets quality, management, earnings, and liquidity (CAMEL). Composite CAMEL ratings reflected existing conditions, but not future possibilities. In recognition of the inadequacy of CAMEL ratings alone, the agencies undertook in the 1990s to develop sensitivity measures for various types of risk faced by banks. Among others, they identified, credit risk, market risk, interest rate risk, liquidity risk, compliance risk and reputation risk.

Growth of Federal Banking Agencies

Deregulation, and the passing of the old regulatory regime, has been accompanied by the emergence of the Federal Reserve as the preeminent bank regulatory agency in the United States. Despite repeated efforts to reduce its direct participation as a regulator, or even to eliminate the System's role in regulation, its authority has expanded considerably (Shull, 2005: 146–8, 151–2).

NON-REGULATED ACTIVITY EXPANSION

Despite the expansive possibilities provided by GLB, Congress, as has been typical, also left a door open for unregulated activity expansion. The Bank Holding Company Act of 1956 exempted one-bank holding companies;

Chapter 2.

Corporate governance in banks: does the board structure matter?

OECD definition of governance

The OECD is an inter-governmental body that is dedicated to sound practices for economic development. It provides an international perspective on the definition of governance. The OECD Principles of Corporate Governance (2004) states that corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders.

Franco-German Model

The Franco-German model of corporate governance incorporates the interests of both shareholders and non-shareholders (stakeholders) such as employees.3 For example, in France, young workers rioted in 2006 over a controversial labor bill – Beginning Workers Contract – that would make it easier to fire workers under age 26 without any reason or notice in their first two years of employment. This social issue is related to corporate governance because worker representatives serve on many European boards, and there is a conflict of interest if management wants to adjust the size of its labor force. On the other side of the world in Japan, permanent/lifetime employment plays a large role in their economy, and in corporate governance.

WHAT DOES THE ACADEMIC RESEARCH SHOW?

Academic research dealing with corporate governance and shareholders' interests yields mixed results, depending on the methodology, data, definitions, time periods used, and what the researcher is trying to prove. A glimpse at recent research on selected governance topics illustrates this point. This is not intended to be an extensive review of the literature. It only provides a brief overview of two selected issues: stock returns and board composition and structure.

Board composition and structure

The second topic is the composition and structure of the boards. Fama and Jensen (1983) argued that having outside directors was a good thing. However, Klein (1998) found little association between overall board composition and firm performance, but she did find ties between committee structure and performance. Increasing the number of inside directors on finance and investment committees was associated with higher stock returns. Hermalin and Weisbach (2003) found that board composition did not predict performance, but board size was negatively related to performance.

Investor Activism

Institutional investors also have a say in management and governance. The California Public Employee's Retirement System (CalPERS) Board of Administration has concluded that 'good' corporate governance leads to improved long-term performance. CalPERS also strongly believes that 'good' governance requires the attention and dedication not only of a company's officers and directors, but also its owners. CalPERS is not simply a passive holder of stock. 'We are a "shareowner", and take seriously the responsibility that comes with company ownership.

Chapter 3.

Corporate governance and bank performance

POSSIBLE RELATIONSHIPS BETWEEN BANK CORPORATE GOVERNANCE AND PERFORMANCE

Bank governance must address a range of issues within a bank, including who will run the bank, what will be the makeup of the board of directors, how will the board carry out its oversight of management officials, and what financial incentives and other factors will be used to align the actions of all these key players with that of stockholders. With regard to who will run a bank, the management or top officers might be composed of the principal owners or be hired from outside this ownership group. While many banks begin operations with major stockholders serving in management positions, a manager might be hired from outside if the owners don't have the background or the experience to run the daily operations of a bank or have other business interests occupying much of their time. Hiring a manager might also be the best option when the principal owners retire from management positions and no other insiders or family members are in a position to manage the bank. Professional or hired managers may further provide a means for stockholders to bring in someone with the needed expertise, experience and outside perspective to run the bank well.

DIRECTORS, MANAGERS, AND STOCKHOLDERS AND THEIR EFFECT ON BANK EFFICIENCY

To analyze the corporate governance framework in banks, we use a sample of state-chartered banks in the Kansas City Federal Reserve District. Each bank in this sample has total assets of under $1 billion. These community banks operate with a wide diversity of management, ownership and board structures, which range from hired managers with little or no stock ownership to owner managers controlling virtually all of their bank's stock.5 Because our sample only contains community banks, various elements of the corporate governance framework that we examine may not be directly applicable to larger banks that are more widely held and face the discipline imposed in actively traded markets. However, many of

the financial incentives facing managers, owners and directors at community banks also have their counterparts in larger institutions.

Boards of Directors and Bank Efficiency

In the corporate governance framework, bank directors have a number of important responsibilities, including hiring and overseeing the management team, setting major policies and objectives, monitoring compliance with these policies, and participating in the significant decisions within the bank. Thus, directors play a key role in setting the parameters under which management is to operate, and board decisions should have a significant influence on a bank's performance.

HOW MANAGERIAL OWNERSHIP AND WEALTH CONCENTRATIONS AFFECT BANK RISK

Managing risk is a complicated task in any firm. Assessing whether a firm is taking an appropriate amount of risk is especially difficult because preferences for risk are an individual matter. Thus, it may not be easy for outsiders to determine if a particular firm is doing well in managing its risk exposure. This becomes even more challenging in banks where a public safety net exists to ensure financial stability and where banks are subject to close oversight by banking agencies. Compared to many other industries, banks therefore face an additional layer of supervisory constraints on the options they consider in managing risk.

Chapter 4.

Corporate governance at community banks: one size does not fit all

A VARIETY OF GOVERNANCE ENVIRONMENTS

AT COMMUNITY BANKS

Over 90 percent of the commercial banks in the US can be described as 'community banks'. There is no strict definition for a community bank: typically, analysts simply define community banks as commercial banks with assets less than $1 billion or $2 billion.1 Community banking companies almost always have a local geographic focus, and make 'relationship loans' to small businesses based on their superior knowledge of local business conditions.

THE ORIGINAL STUDY

One key objective of the original Chicago Fed study was to construct a database to describe the corporate governance environment at community banks. The data analyzed here were constructed from previous bank examination records, internal supervisory databases, interviews with bank managers, and internal bank documents.

EXTENDING THE ORIGINAL STUDY

The original study generated some interesting results about the financial impact of governance conditions and practices at community banks – results that agree with existing theories and anecdotes about incentive structures facing bank managers and bank directors.

Chapter 5.

Bank mergers and insider trading

MERGERS AND INSIDER TRADING LITERATURE AND LAWS

This section reviews literature and laws pertinent to our study. First, we consider how bank mergers affect the insiders at target banks. Second, we discuss the literature on insider trading prior to merger activity. Third, we examine the applicable insider trading laws. Finally, to determine the effectiveness of current regulations, we review recent studies on insider trading.

DATA

In this section, we describe the sample of target banks, the matched control sample, and the insider trading data for both samples.

Target Sample

Our sample of bank merger targets was obtained from the Securities Data Corporation Platinum (SDC) Merger and Acquisitions database. We examined merger and acquisitions announcements for deals $100 million or more during the period 1995–2005.

The Matched Control Sample

Firms are matched according to size and industry. We define industry using the first two digits of firms' SIC codes. We measure size using total assets from Compustat. The two-digit SIC codes of the target banks are either 60 (depository institutions) or 67 (bank holding companies and other investment offices). Total assets are observed at the end of year, one year prior to the merger announcements.

RESULTS AND ANALYSIS

We use simple methodology to systematically analyze the presence of informed insider trading. Insider trading tends to be infrequent. We find that, on average, there is less than a 25 percent chance that insiders of a particular bank either buy or

sell their bank's shares during a given month. Hence, the insider trading data is highly non-normal and not suitable for regression analysis as a dependent variable.3 Therefore, our analysis relies principally on univariate tests such as matched pair *t*-test and Wilcoxon signed rank tests.

Chapter 6.

Conflicts of interest and corporate governance failures at universal banks during the stock market boom of the 1990s: the cases of Enron and WorldCom

UNIVERSAL BANKS AND ENRON

Enron was one of the most glamorous and admired companies during the stock market boom of the late 1990s. Enron's reported revenues increased from less than $10 billion in 1995 to $20 billion in 1997, $30 billion in 1998, $40 billion in 1999 and $100 billion in 2000. Enron's market capitalization reached $70 billion at its peak in August 2000. Measured by reported revenues and market capitalization, Enron was the seventh largest corporation in the United States. For five consecutive years, from 1997 through 2001, *Fortune* magazine ranked Enron as the 'Most Innovative Company in America'.

Universal Banks as 'Enablers' of Enron's Fraud

Neal Batson, Enron's bankruptcy examiner, determined that '[t]here is sufficient evidence from which a fact-finder could conclude' that nine universal banks 'had *actual knowledge* of the wrongful conduct of [Enron's] officers' and 'gave *substantial assistance* to the officers by participating in the structuring and closing of the SPE transactions'.

The Banks' Awareness of Enron's Fraud

Enron's bankruptcy examiner determined that the SPE transactions disguised $14 billion of debt obligations by moving those obligations off Enron's balance sheet.52 The banks were well aware that Enron was using SPE transactions to mislead investors, analysts and credit ratings agencies by inflating its reported cash flows and earnings and by hiding debt. Credit Suisse and RBS also recognized that their involvement in LJM1 enabled Fastow and his associates to receive improper self-dealing benefits. Despite this knowledge, the banks viewed Enron as a highly

desirable customer, and they disregarded the financial and reputational risks created by Enron's manipulative transactions.

UNIVERSAL BANKS AND WORLDCOM

The Rise and Fall of WorldCom

The chronicle of WorldCom's rapid ascent and sudden collapse resembles Enron's story in a number of respects. Like Enron, WorldCom grew from humble beginnings to become a leading 'New Economy' firm and a favorite of institutional investors during the late 1990s. Like Enron's officials, WorldCom's managers sought to pump up their company's stock price by promising to meet aggressive earnings targets set by Wall Street analysts.

Chapter 7.

Basel II: operational risk and corporate culture

BASEL II

The New Basel Capital Accord (hereafter called Basel II) replaces the 1988 Capital Accord (Basel I). Whereas Basel I has a simple one size fits all 8 percent capital standard for banks, Basel II is very complex; and is targeted primarily at large complex financial organizations (LCFOs). By definition, LCFOs are internationally active

Corporate Culture

In dealing with operational risk, Pillar 2 – the Supervisory Process – states that a bank's framework for managing operational risk 'should cover the bank's appetite and tolerance for operational risk'.4 The extent to which this is done depends largely on a bank's corporate culture. Every organization has a corporate culture. The Basel Committee on Banking Supervision (February 2003, p. 1) defines operational risk culture as 'the combined set of individual and corporate value, attitudes, competencies and behavior that determine a firm's commitment to and style of operational risk management'.

Red Flags

Red flags represent warning signs. In this section, we present six indicators that may give clues about potential operational risk problems.

Ineffective internal controls

As previously noted, corporate culture 'is the way we do things around here'. That definition also applies to internal controls – 'the checks and balances against undesired actions and are essential for banks to operate in a safe and sound manner'.16 To some extent this is accomplished by having rules that must be followed and documentation to show that they were followed. However, having

rules and documentation is necessary, but not sufficient to provide internal controls.

THE ROUTINE ACTIVITIES THEORY

Cohen and Felson (1979) developed the ‘Routine Activities Theory’, that is widely used in criminology to explain certain types of crimes, such as theft. The theory has three main elements: a motivated offender, a suitable target, and absence of a suitable guardian. In other words, the theory deals with the means, motive, and opportunity to commit crimes.

Chapter 8.

A cross-country analysis of bank performance: the role of external governance

REVIEW OF SELECTED LITERATURE ON EXTERNAL GOVERNANCE IN BANKING

Overview

A widely accepted definition of corporate governance is provided by Shleifer and Vishny (1997), who define corporate governance as the ways in which investors ensure themselves that they will receive maximum return on their investments.1 Key mechanisms of an effective governance framework include ownership (including institutional and managerial ownership),

Strength of external audits

The objective of external financial reporting is to reduce information asymmetries between the different stakeholders of a company (Healy and Palepu, 2001). Audited financial statements are important for countries where firms rely more on equity finance than on debt for funding. The corporate governance role of audits in markets or industries where firms rely more on debt may be less important, as debtholders generally have greater access to financial information than individual shareholders.

External ratings and credit monitoring

Credit rating agencies, such as Moody's and Standard and Poor's, rate certificates of deposit, debentures and commercial paper. Credit rating agencies also rate banks. For some types of activities, regulators actually require banks to be evaluated by credit rating agencies. For example, in the United States, banks must have an external rating in order to issue letters of credit (DeYoung *et al.*, 2001). In addition, Basel II requires that regulators use ratings in assessing banks' strength.

CROSS-COUNTRY DATA

The primary focus of our inquiry is on the effect of external governance on bank performance. To measure the impact of the external governance framework we rely on a recent survey conducted by the World Bank.12 It covers 152 countries and provides data for end-2001 and 2002. The focus of the survey is on bank regulations and supervisory practices. Using the survey data, we extend the work of Caprio and Levine (2002) in constructing an External Governance Index (EGI). The EGI consists of four basic components: (a) the type of accounting standard employed (ACC); (b) the strength of external audits (SEA); (c) the transparency of financial statements (FST); and (d) the use of external ratings and reliance on credit monitoring (ERC). SEA captures the mandated procedures for ensuring the use and quality of independent auditors, and the ways in which regulatory authorities interact with auditors. FST captures the level of mandated information disclosure to the public. ERC measures the mandatory use of credit rating agencies and subordinated debt. ACC is a dummy that takes the value of one if banks in a country use IAS, US GAAP, or both. The external governance index is the summation of these sub-components. As an alternative, the external governance index is also calculated as the summation of the sub-components weighted by each component's maximum score (EGIEW).

Chapter 9.

A survey of corporate governance in banking: characteristics of the top 100 world banks

PERSPECTIVES AND RECENT RESEARCH

Recent research shows that good firm performance is linked to good corporate governance.However LeBlanc and Gillies (2003) suggest the evidence is not as strong as many report, this is also supported by Chidambaran et al. (2006) who find no significant performance differences between firms with good or bad governance changes. Gompers et al. (2003) developed a governance index based on 24 firm specific characteristics around shareholder rights and found that high governance index firms had higher firm value and profits. Brown and Caylor (2004) develop a governance index based on 51 governance factors. They also find higher governance scores drive return on equity and profit margins whilst Core et al. (2006) contend that weak governance did not cause problems with stock returns

METHODOLOGY

In this study we examine the corporate governance characteristics of the world's top 100 banks. The term bank in this study is used generically to refer to the entire operations of the reporting entity as disclosed in their consolidated annual report, not just their banking operations. The ranking of the top 100 banks was obtained from Forbes.com 2005 listing of the world's top 2000 companies.

RESULTS OF THE STUDY – COMPARISON TO THE AVERAGE BANK

This section reports the overall summary results of the survey. The world's top 100 banks come from 28 countries. Refer to Appendix A for the list of banks. The US dominates with 26 banks and the next largest countries are Japan and the United Kingdom with eight each. Twelve countries had just one bank, Appendix C contains a list of the countries represented in the survey and the number of banks. In compiling the data from the banks' annual reports it was observed that there are

a number of differences in how the top banks are governed from director numbers, committee structures, number of internal directors and independence of the chairperson. Table 9.3, Panel A provides a summary of the average bank plus maximum and minimum values for each item across the sample. Table 9.3, Panel B shows percentage compliance with board governance characteristics. The verage bank in the survey will have 14 directors and 25 percent will be internal. Banks on average hold ten board meetings a year and the directors have served almost eight years on the board. The average bank will have a board statement on corporate governance, an audit, compensation, and risk committees.

Board of Directors

Many studies have indicated that board size is seen as being important in good corporate governance. The average bank board has 14.6 directors with 3.7 (25 percent) being internal members. Not all banks reported remuneration for their non-executive directors therefore there was no meaningfull data to analyse. The governance code in the United Kingdom suggests independent directors should not serve for more than ten years and the chairperson of the board should be external. This study revealed the average number of years' service that directors have served on a bank board is approximately seven and half.

Board Committee Structures

All banks reported on their corporate governance practices however only 72 percent reported a board policy on risk setting and 77 percent of banks have a risk committee. In an industry where risk management is very important and forms part of the new Basel II capital adequacy requirements this seems a low compliance rate. Eighty-nine percent of banks had a compensation committee and the composition of this committee varied with 56 percent having all external directors. All banks other than the Japanese banks had an audit committee but only 67 percent of the banks had all independent members. The Japanese banks have an audit board instead of an audit committee.

Return on Assets and Equity

The average banks return on assets is 0.96 percent and return on equity 14.7 percent. The Japanese and French banks had the lowest return on assets at 0.3 percent and 0.4 percent respectively. The French banks have lower levels of equity than the other banks and a larger reliance on debt therefore higher leverage. The Japanese banks are improving their performance after the well-publicized problems of past loan losses. The return on equity was also low for the Japanese banks at 8.3 percent.

Chapter 10.

Corporate governance: the case of Australian banks

STRUCTURE OF CORPORATE GOVERNANCE IN AUSTRALIA

Corporate governance is difficult to define broadly because this field of inquiry requires a definition that is limited to the researchers and practitioners in the broad area of commerce. Since the organizational structure in a bank-like entity to enhance corporate governance specifically is in the broader area of organization literature, it is perhaps legitimate to borrow a definition from that literature.

Board Control

At the societal level, the first specific governance law was the Banks (Shareholdings) Act of 1972: this was aimed at limiting the power of majority shareholders and freeing the Board to have full power.1 This law limited the concentration of power of individual shareholders of the bank.

Uniform and Focused Supervision

The second set of policy changes were aimed at improving the overseeing of banking activities as well as improving competition in the industry. From the outset in 1941 to the present, a series of reforms (often resulting in new laws) were introduced to bring all bank-like institutions under the supervision of prudential authorities. The prudential supervision of some statelicensed banks fell within the state, outside the federal powers, which fostered bad banking practices, and in two cases bank fraud. From a bank (Commonwealth Bank) acting as the supervisor of all federally-licensed banks in 1941, Australia improved the governance of banks by bringing all banks under the supervision of the Reserve Bank of Australia (1959 Reserve Bank Act) and the Australian Prudential Regulatory Authority, APRA, for supervision of financial institutions in 1998. These two steps enabled all banks to be supervised by a central authority thus contributing to the improved prudential governance under uniform rules by an independent authority. Separation of banking supervision from the Reserve Bank to the APRA enabled attention to be focused more on the issues particular to the banking (and insurance) industry: a lesson from the reforms in the UK just few years earlier. Concomitant with these

major changes were the attention given to establishing greater competition among the banks. In 2000, with the release of APRA's Ten Harmonized Prudential Standards, banking operations increasingly became uniform as well as thus leading to the regulator permitting greater market-based self-regulations within that framework.

Competition

The adoption of the 'six pillars' policy was abandoned in favour of the 'four pillars' policy in 1998 so that mergers of banks other than outside the core four banks were encouraged to create scale economies and full-range banking businesses. Even prior to that, the regulators permitted, first, the creation of new banks and later invited foreign banks to enter the market in the late 1980s.

Basel Guidelines

The provisions that came in by the way of Basel guidelines relate to risk management in banks. There is a strong practical reason for interpreting bank reports to be adjusted for the different riskiness of the assets reported by a bank for public information. In a sense, good corporate governance dictates that the bank management must practice good governance in knowing the risk-adjusted size of their reported assets. Hence, any adoption of Basel recommendations should also be looked at as part of corporate governance, not simply as good reporting practice.

SURVEY OF THE LITERATURE

There is a modest literature on governance in general, and a smaller subset of studies on corporate governance. This brief review is limited to the seminal works in this area drawing attention thereafter to the limited Australian literature. That proper corporate governance institutional framework is important has been prompting, for over 100 years, the passing of laws of good governance in modern societies. Our citations are limited to just two: Carlton *et al*. (1998) and Klein (1998). There are also other studies on broader governance issues: see Hart (1995). More relevant to the subject of this discussion are corporate governance issue papers. These may be broadly divided as follows: Board composition studies; Board and CEO remuneration studies; Board independence studies; ownership and performance studies; and finally, a set of Australian studies.