

Governance and Australian Financial Institutions

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Abstract

This paper examines issues of corporate governance arising from the activities of financial institutions and markets. It is argued that governance problems are particularly severe in financial institutions *vis a vis* firms in other industries, and particularly important for society given the central role of financial institutions and markets in the financing and corporate governance activities of the economy. Processes of financial reform and financial system design have, it is argued, generally paid inadequate attention to governance considerations. The paper: examines some of the public policy issues related to governance *of* financial institutions; discusses some of the problems evident in governance *within* financial institutions; and considers emerging issues and trends in the governance role *of* financial institutions in the broader economy.

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“Structural changes in financial markets have led to the emergence of new financial instruments, increased integration of markets, stronger competition and new or radically changed financial institutions. These developments are having an important impact on the functioning of financial governance channels, although not all consequences are well understood.” OECD (1997)

1. Introduction

The Australian financial system has undergone marked structural change in the last two decades, prompted by the forces of deregulation, technological change, and financial innovation. Those forces have changed the environment within which financial firms operate and the ways in which activities are undertaken. Financial firms, however, still undertake the same basic economic functions of bringing together surplus and deficit units and absorbing, transforming and shifting risks associated with the resulting financial transactions and balance sheet positions¹.

In the past, much of the analysis of financial firms and markets has focused on the somewhat mechanical characteristics of how these functions are performed, largely ignoring the important issues of decision making processes and incentives of participants which are crucial to efficient performance. More recently, attention in the academic literature has become focused on corporate governance issues as they relate to financial institutions, reflecting a greater interest in governance in both the academic and public policy spheres². While governance issues have important implications for the design and regulation of financial systems, they have not played as important a role in the reform processes of financial systems as they might. The Wallis Inquiry, for example, paid relatively little explicit attention to governance issues, although several of its recommendations relating to areas such as mergers and acquisitions, information disclosure, prudential regulation, spread of ownership requirement, transferability of superannuation fund membership, etc., have implications for governance mechanisms and structures.

¹ Some authors such as Allen and Santomero (1997) have, however, argued that technological change has meant that functional activities based on existence of transactions costs and asymmetric information have become less important relative to others such as facilitation of and access to risk management activities.

² Dunlop (1998) provides an overview of recent international reports and recommendations on corporate governance from an Australian perspective.

John and Senbet (1998) define corporate governance in the following way.

“Corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected” (p372).

Such a definition, although commonly used, tends to focus on the relationship between outsiders and insiders in an organization and a broader definition is provided by Keasey and Wright (1993) who define corporate governance to include “the structures, process, cultures and systems that engender the successful operation of the organisations”. Since governance thus involves issues of disclosure (of information), codes of conduct (for directors and other agents), and internal organisational structures, an immediate concern which arises concerns the relative roles of legislation /regulation and market forces (including self-regulation) in achieving “good” governance practices.

The motivation for this paper is the view that such governance issues are particularly (and increasingly) significant in modern financial firms (and markets) and for their role in the economy, and that financial reform processes have not taken adequate account of this role. Reasons why governance issues in financial firms and financial markets are of particular importance are as follows.

First, the nature of the financing process means that financial firms are often “opaque” in nature, giving rise to significant information asymmetries that underpin governance problems. While opaqueness is typically seen as a characteristic of intermediaries, it is also relevant to *collective investments* such as mutual funds. Chevalier and Ellison (1997), for example, note that information deficiencies create problems for investors in risk-adjusting the returns generated by fund managers in order to assess performance, while Dow and Gorton (1997) argue that investors are unable to judge fund manager expertise from their actions or inaction. Both of these studies suggest that fund managers may, as a consequence, undertake trading activities which may not be socially optimal.

Second, while operations of financial institutions have always involved some delegation of decision making and risk taking responsibilities, the relative importance of this is changing. The changing nature of employee and management activities

within financial firms, away from traditional activities such as transaction processing and toward decision oriented activities in a deregulated environment, give rise to greater potential for risk and outcomes not expected or desired by other stakeholders in those firms.

Third, governance is an activity in which communal benefits from private actions lead to inherent *free rider* problems. Regulatory and supervisory arrangements in the finance industry can thus be expected to have the effect of weakening the incentive for the private sector to undertake other typical governance functions.³

Fourth, financial firms play an important role in the governance of other institutions: as holders of equity stakes with voting rights; as credit providers and, consequently, monitors of performance; in investment and advisory roles impacting on asset values and takeover possibilities. How problems in governance *of* financial firms interacts with the governance roles *of* financial firms is an important question. Shleifer and Vishny (1997, p 761) for example note that “...large investors ...may be soft when they themselves are corporations with their own agency problems”. In particular, “... banks may have no incentive to discipline managers and some incentive to cater to them to get more business, as long as the firm is far away from default”.

Fifth, financial innovation is potentially weakening traditional governance processes. For example, equity investments have the dual characteristic of entitlement to returns and control rights (votes), but financial innovations can separate these characteristics. *USUs*, for example, were a failed innovation attempted in the US capital market in the mid 1980s which would have “unbundled” the characteristics of ordinary equity into separate components involving entitlement to capital gain, entitlement to a “standard” dividend, entitlement to “excess” dividends, and voting rights. More recently there has been a dramatic increase in the growth of third party issued warrants on equities. Investors in these warrants receive returns linked to those on the underlying shares, but have no voting rights. Issuers of the warrants may purchase the underlying stock as a hedging transaction, but – since they are hedged – may have no incentive to exercise the associated voting rights. Growth in credit derivatives also has potential

³ Takeovers may be inhibited, spread of ownership requirements may exist, prudential supervision and investor protection may weaken product market discipline.

implications for governance processes and incentives, by separating the bearing of credit risk from the origination, funding, and management of loans.

Sixth, increased competition in financial markets (often linked to deregulation), together with increased reliance on securities market financing rather than intermediated debt, may lead to a decline in “relationships” between financial institutions and business borrowers and subsequent changes in monitoring and long term commitment by the former.

These governance aspects lead to a three-way classification of governance issues involving financial firms around which this paper is structured. First, there is the issue of the governance *of* financial institutions by external stakeholders such as equity holders, credit providers, investors (in collective investments), and government. Second there is the largely neglected topic of governance *within* financial institutions, involving the questions of determination of intra-firm structure, transfer pricing and performance measurement, and risk sharing and management⁴. Third, there is the role of financial firms and markets in the governance process more generally as monitoring institutions, and the important issue of how changing financial market structures may impact upon the efficacy of governance mechanisms in the economy generally.

Section 2 of the paper provides some background discussion of the recent evolution of the Australian financial system with a focus on governance issues, and this is followed in section 3, by a brief review of the literature on agency problems and governance in financial institutions. The subsequent three sections consider the three aspects of governance outlined above, and this is followed in section 7 by some concluding comments.

2. Financial System Development and Governance in Australia

The Australian financial system was fundamentally transformed by the financial deregulation of the early 1980s which removed restrictions on management discretion in financial institutions, promoted competition in the financial services industry, and removed institutional restrictions which inhibited the development of broad based

⁴ Kimball (1997, 1998) provides valuable overviews of these areas.

financial services firms. I have argued elsewhere (Davis, 1995) that the deregulation of the early 1980s was, with the aid of hindsight, deficient in treating financial firms as “black boxes” and ignoring the agency issues and governance problems inherent in such institutions.

Prior to deregulation, managers of financial firms had limited discretion, were subject to muted competition, and other stakeholders had limited incentive to actively monitor managerial activities. Deregulation removed constraints on management and provided incentives for them to undertake new activities. Some have also argued (in the US context) that by reducing the franchise value of banks (through increased competition) deregulation gave bank owners an incentive to increase risk taking (see Demsetz, Saldenber and Strahan, 1997). Deregulation did not, however, simultaneously provide for enhanced governance mechanisms in the newly deregulated environment. Both government regulators and private stakeholders, with little experience of how to assess performance in the new environment, were caught unawares by the risk taking and poor decision making which subsequently ensued. Perhaps of equal significance was the ultimate recognition of inadequate internal governance mechanisms within financial institutions to cope with the new environment – leading to some unpleasant surprises for senior management, boards of directors and external stakeholders⁵. Yet another aspect was the role of financial institutions in facilitating the takeover wave of the 1980s, possibly undermining the effectiveness of the market for corporate control by indiscriminate financial support of acquisitive entrepreneurs.

Subsequent developments in supervisory practices applying to financial intermediaries have partially addressed those issues. Capital adequacy requirements introduced in the early 1980s and refined to reflect credit counter-party risk in 1987 and market risk in 1996 can be seen as a response to the agency problems arising between depositors and owners, and ultimately impacting on government through implied or explicit guarantees. Such capital requirements however, do little of themselves to enhance governance mechanisms relating to control of and incentives for management performance. More recently, greater focus on supervisory inspections of internal systems and processes can be seen as recognition that intra-

firm governance arrangements can be as important for the interests of individual external stakeholders as are the relationships between external stakeholders.

The significance of intra-firm governance arrangements for external stakeholders in financial firms is potentially enhanced by the impact of technological change on the finance industry. It is noticeable that while the financial sector continues to increase in size, as measured by assets held or managed, the employment share of the industry is shrinking (Davis, 1997). Traditional routine activities such as transaction processing are being mechanised and the focus of employment in the industry turning more towards advisory, assessment, management and trading activities where, it may be argued, the measurement of performance and control mechanisms are not well developed. The ability of financial firms to develop adequate internal structures and systems to ensure that the necessary delegations of decision-making responsibility achieve outcomes consistent with senior management and/or external stakeholder goals is not immediately obvious. Casual empiricism would suggest that internal organisational restructuring is the norm rather than the exception in the finance industry over the past decade, as institutions search for suitable structures to deal with both new activities and new approaches.

Changing governance arrangements arising from conversions by financial firms to different organisational types have also been significant. A recent trend (both in Australia and overseas) has been the conversion of many financial organisations from mutual form to joint stock form involving a greater separation of owners and customers, and different governance arrangements. At the start of the 1980s, private joint stock companies held only slightly over 50% of banking sector assets, stockbrokers were partnerships, mutuals dominated the life assurance industry, mutual building societies and credit unions (cooperatives) were increasing in importance, and the authorised exchanges were mutual organisations. Since then, the financial markets have been increasingly characterised by institutions converting to the joint stock form⁶ (although *collective investments* have grown in significance).

⁵ An excellent case study of problems that emerged in one major Australian bank can be found in Carew (1997).

⁶ Reserve Bank of Australia (1999) provides comprehensive information on Australian demutualisations.

Another trend in the Australian financial system, with broader implications for corporate governance, has been the changing pattern of financial flows. The relative growth of funds management and direct financing *vis a vis* intermediation is well known (see, for example, Davis, 1997) and has a number of consequences for corporate governance. One concerns the governance arrangements of *collective investment* vehicles such as mutual funds, superannuation schemes etc., where no distinction between owners and customers exists, and nominated and/or elected *trustees* fulfil the role normally played by directors. Another concerns the question of whether fund managers controlling those collective investments adequately fulfil the governance function expected of equity stakeholders. Another issue concerns the relative governance characteristics of a bank-based versus capital-markets-based financial system, and how the performance of the governance function will evolve with the changing face of the financial system.

Although the Wallis Inquiry did not focus particularly on governance issues, that topic is an important component of the Corporate Law Economic Reform Program (CLERP) instituted by the Federal Government in 1997⁷. However, it is by no means clear that this process will be able to take the broad perspective necessary to assess the role, and appropriate treatment, of the financial sector in regard to governance issues.

3. Agency Problems, Governance, and Financial Institutions

Keasey, Thompson and Wright (1997) suggest four alternative paradigms which attempt to explain the causes of corporate governance problems and which sometimes generate conflicting suggestions for solutions. The *Abuse of Executive Power* model sees boards as self-perpetuating oligarchies who have gained control over corporate assets, and who pursue their own self-interest, largely unchecked by external market mechanisms. The *Myopic Market* model is based on a view of capital market failure, which involves an over-emphasis on short-term outcomes at the expense of socially beneficial longer-term strategies. The *Stakeholder* model adopts a premise that the objective function of the firm should embrace more than just shareholder wealth maximization, to include the well-being of other stakeholders with a long-term association with the firm. In some cases (such as where efficient production rests on

long term implicit contracts) the social welfare benefits of such an approach can be derived from the dominant *Principal-Agent* model, which sees corporate governance arrangements as the market solution to the agency problem arising from separation of ownership and control in a world of imperfect information.

Agency issues permeate the entire structure of financial firms. Diamond (1984), for example, has characterised banks as ‘delegated monitors’ arguing that their activity of intermediation involves assuming responsibility as delegated principals in the monitoring of ultimate borrowers. A similar argument, in the context of equity investments, can be made for the role of fund managers. Dow and Gorton (1997) for example, examine the implications of “delegated” portfolio management in a world of imperfect information and note that noise trading by fund managers may result – providing one possible explanation for the high trading volume observed in financial markets.

It is interesting to note, as a digression, that the paradigm of modern portfolio theory on which the funds management industry rests is based on a complete disregard for the monitoring role associated with investing in risky assets. In essence, portfolio theory ignores the control aspect associated with equity ownership, focusing solely on return characteristics, and *assumes*, inconsistently, that all investors are, in effect, price takers who can free ride on the expenditure of resources on monitoring by other investors (or alternatively, that monitoring is unimportant).

The reality is that delegated monitoring is a characteristic of both intermediation and funds management. Given the opaqueness of both types of financial institutions, a chain of agency problems thus exists involving governance *of* financial firms and the role of such firms *in* governance of other entities.

In practice there is a wide range of potential agency problems in financial institutions, involving at least four major stakeholder groups. They are shareholders, depositors/investors, management, and government/supervisory bodies⁸. Agency problems arise because responsibility for decision making is (explicitly or implicitly) delegated from one stakeholder group to another, in situations where objectives

⁷ Walter (1998) provides an overview of CLERP.

⁸ A broader list would include borrowers and other recipients of financing, as well as employees.

between stakeholder groups differ and where full information, enabling control to be exerted over the decision maker, is not readily available.

Undoubtedly, the most studied agency problems in the case of financial institutions are those involving depositors and shareholders or government and shareholders. While that perspective underpins the major features of the design of regulatory structures (capital adequacy requirements, deposit insurance / depositor protection etc.), problems of incentive conflict between management and owners have become a focus of recent attention⁹.

The agency problem between depositors and shareholders reflects the typical conflict between debt-holders and stockholders. In the case of banks, these problems take on particular significance because the nature of the deposit contract prevents priority ranking being given to current depositors over future depositors. This is aggravated by the absence of a secondary market in (most) deposit claims which means that there is no secondary market price which makes information observed (and acted upon) by some depositors more widely available.

The resulting view that financial markets can be subject to inherent instability induces governments to intervene to provide depositor protection in some form or other. Explicit deposit insurance is one approach, while explicit or implicit guarantees of deposits is another. In either case, general prudential supervision also occurs to limit the risk incurred by the insurer or guarantor. Where governments relieve depositors of risk, by guarantees or deposit insurance, they are effectively providing the owners of the bank with a free put option over the assets of the bank, enabling them to honour deposit obligations under all circumstances and converting deposits into risk free assets. (Alternatively, government protection can be interpreted as the government granting a put option to depositors, which offsets the put option granted by depositors to the bank owners, and thus removes their incentive to monitor bank actions.)

To control the incentive of bank owners to increase the value of the put option granted to them by deposit insurance or implied guarantees over deposits, governments typically enforce some controls over bank owners. These can involve limits on the range of activities (thereby possibly limiting the risk of the

⁹ See, for example, Prowse (1995).

organisation); linking deposit insurance premiums to risk; and linking capital adequacy requirements to business risk (thereby enforcing some element of risk sharing between government and owners).

While such controls may overcome the agency problem between government and bank owners, it must be asked how significant this problem is in reality. Few problems of instability in the Australian financial sector appear to be traceable to outside owners attempting to increase the riskiness of their institutions in order to exploit government guarantees. Rather, most causes for concern relate instead to management decisions which reflect agency problems involving management. Management may have different risk preferences from those of government and/or owners, or limited competence in assessing the risks involved in its decisions, and yet have significant freedom of action because of the absence of adequate control systems able to resolve agency problems.

An important feature of financial systems has been the past significance of mutual and cooperative organisations. Quite different agency problems and governance issues arise here. Even if a "collective" objective function for owners' preferences can be identified for management goal setting, the ability of members to control managers is limited by diffusion of ownership and the absence of equity market discipline. Managerial objectives may dominate decision making unless adequately constrained. An important question then is what institutional constraints are imposed to ensure managerial compliance with owner objectives.

Previous literature has pointed to a number of benefits which may arise from the cooperative form, an important feature of which is the nature of agency problems arising from their institutional structure. On the one hand, the coincidence of owners and creditors (the depositor/members are the owners) eliminates the well known agency costs associated with debt and equity - providing cooperatives with a potential competitive advantage over profit oriented institutions. On the other hand, agency problems arising from the divergent objectives of management and owners may be severe. Because of the one member - one vote rule, the ability of any member to generate a concentration of voting power may be limited, thereby increasing the job security of management and their ability to award themselves excessive remuneration.

4. Governance of Financial Institutions

In this section, the focus is upon the mechanisms by which external stakeholders might exert influence upon senior management to ensure that policies and strategies are consistent with stakeholder goals. Typically, the mechanisms involved can be classified under headings of design of compensation schemes, monitoring processes, and capital market (takeover threat) discipline.

Commencing with the issue of monitoring processes, an important preliminary question concerns the extent to which monitoring by private sector stakeholders based on disclosure of information by financial institutions can substitute for monitoring by regulatory authorities. The dilemma lies in the opaque nature of certain types of financial institutions, and the ability of external observers to adequately assess performance – particularly when disclosure cannot involve commercially sensitive information. While regulatory authorities may be able to access and interpret such information, regulatory monitoring can be expected to induce a decline in monitoring by creditors and create an expectation of regulatory responsibility for compensation in the event of failure. Given the free-rider problem when there are numerous external stakeholders (so that no depositor has sufficient incentive to expend resources on monitoring) it is difficult to see how disclosure alone can suffice¹⁰. However, it is worth noting the role of capital adequacy requirements which lead to significant use of subordinated debt by financial institutions as “Tier 2” capital. The relatively sophisticated wholesale market providers of such debt may be able to gain access to (or better interpret) information than other stakeholders, and have enhanced incentives to monitor due to their subordination to depositors.

Turning to monitoring by owners, an important issue concerns the role of the Board of Directors as representatives of the shareholders with responsibility for monitoring management. As John and Senbet (1998) note, practice diverges markedly from the simple theory which sees directors as elected representatives of shareholders pursuing

¹⁰ The New Zealand experiment with a disclosure regime and minimalist government regulation provides an interesting case study, although one whose results are contaminated by the fact that virtually all New Zealand financial institutions are foreign owned and subject to supervision by foreign regulators. (See Davis, 1999, for details).

the interests of that latter group. Recent analyses have focused upon the self interest of directors, in essence recognising the existence of another layer of agency problems as directors act as agents for shareholder principals, and the imperfections in the market for directors. Rarely, it would seem, are directors of financial institutions in Australia subject to a true “market test” of shareholder election or censure based on poor performance of the institution involved.

External monitoring can come from, or be induced by, interrelationships between firms operating in similar markets. An important source of monitoring has at times been that arising from competitors who are part of an industry guarantee fund. Under such an arrangement, all institutions contribute to a fund which is available to the regulatory body for making good losses of a failed institution. As Lee, Mayers and Smith (1997) explain, cross-institution monitoring can occur to prevent excessive risk taking by some institutions which could eventually impact on others via increased required contributions.

Cross-institution monitoring may occur for other reasons. One is via direct losses due to counter party exposures. Another is via externality effects involving, in extreme cases, contagion. How competitors act on information gained by such monitoring without creating systemic problems is problematic. Action by *exit*, such as withdrawing investments or reducing counterparty limits can create liquidity problems and hasten the demise of the institution. Action by *voice*, if in the public arena can provoke crisis. If in the private arena, issues of anti competitive behaviour may be raised, and the effectiveness of private warnings must be considered. It would seem likely that a case can be made for regulatory bodies to act as recipients of such information and be in a position to act upon it.

Within Australia (and elsewhere) a significant change in external governance arrangements has occurred in the conversion of mutual financial institutions to joint – stock form. Major Life Offices and Building Societies have converted from mutuals to joint-stock form, as has the Australian Stock Exchange.

There are (at least) two alternative explanations for this trend.. One view, perhaps best referred to as the Efficient Markets - Invisible Hand view, applies the Darwinian survival of the fittest perspective to suggest that market forces lead to efficient

organisational forms surviving. In this view, those organisational forms which best solve the contracting problems associated with a particular activity will survive and prosper. Conversions from one form to another, in this view, indicate recognition that a more efficient organisational form is available, reflecting changes which have occurred in the external environment. Note however, that the external environment prompting such changes includes regulatory and tax factors, such that a particular form may have no inherent advantages but be better suited to coping with a particular regulatory or tax regime.

Fama and Jensen (1983a, 1983b) have provided an analysis of alternative organisational forms which adopts this “efficient markets” view. They distinguish decision management and decision control aspects of business organisations. Where decision management is a complex task (such as commercial banking), the agency problems created by separation of ownership and control are argued to warrant the joint stock form. Decision control by “exit” (withdrawal of funds) is not viable given the illiquid nature of assets, thus requiring decision control by “voice” (voting rights). In contrast, where exit is a feasible control mechanism (unit trusts, thrift organisations ?), a mutual organisation may be efficient since it avoids owner - creditor agency problems. A consequence of this argument is that where governments step in to ameliorate owner-creditor problems via deposit insurance, guarantees, prudential regulation etc., inherent advantages of mutual/cooperatives may disappear – prompting conversion to joint-stock form.

A recent analysis of factors prompting “efficient” conversion is provided by Hart and Moore (1997), focusing particularly on the structure of exchanges. They argue, based on an analysis of voting mechanisms, that as a governance mechanism, outside ownership becomes more efficient relative to a cooperative as membership interests become more diverse, and as competition increases. Given technological developments which have enabled an unbundling of activities and increased competition, together with a need for significant capital expenditures to implement new technology (creating financing problems for cooperatives) modern movements towards the joint stock form might be expected.

An alternative (polar) perspective on choice of organisational form might be called the Exploitative - Self Interest view. In this view, organisational form is chosen by the

promoter(s) of the organisation to maximise the gain to the promoter in an imperfect world. In this view, conversions from one form to another reflect the self interest of decision makers, and are exploitative - aimed at redistributing wealth between stakeholders in the organisation, even if there is no gain (or even a loss) in efficiency from the new form. Where organisations have built up significant communal wealth, there may be an incentive for managers, and certain members, who will gain a disproportionate share of the private wealth benefits from conversion to institute such a change.

Important issues also relate to governance of collective investments. For some such arrangements, such as mutual funds, governance arrangements are simplified by the ability of investors to easily *exit*, by sale or redemption of their investment. However, for that to be a viable form of discipline on management, it is necessary for investors to have adequate information to enable them to assess the likely performance of management. Exit after the event when, in the extreme case, there is nothing left to withdraw, is hardly likely to be an effective form of discipline. Publication of ex post performance measures is thus, at best a partial requirement for effective investor discipline – particularly if (when) there is little intertemporal correlation in performance, or information available to investors which would enable them to calculate “risk adjusted” performance. Given modern technology, there would seem to be little reason why fund managers could not make continuously available such information as portfolio composition.

In the case of other types of collective investments such as superannuation funds, the option of *exit* is often not readily available (although the Wallis Inquiry recommended greater freedom of choice). Moreover, there is little evidence that investors have significant opportunity to exert an influence by *voice*. Boards of trustees are typically a mixture of nominees/appointees and elected representatives¹¹ – where the one member –one vote mechanism (despite its democratic nature) limits the ability of informed members to exert significant influence on board of trustee membership.

5. Governance within Financial Institutions

¹¹ Olsberg (1996) provides information on the role of superannuation trustees.

Financial firms have become large complex organizations involving significant delegations of decision-making and risk-taking responsibility. Even where goals of top management are aligned with those of external stakeholders, the design of internal systems which ensure that the outcome of delegated decision making is goal congruent is a complex matter. By way of illustration, a relatively small Australian Bank sets out in its 1996 Annual Report (Adelaide Bank, 1996) its approach to corporate governance, and lists as board committees those of Audit, Credit and Risk, Asset and Liability, and Remuneration, together with arrangements for internal controls involving regular reporting procedures. Given the complexity of the issues involved in such matters as credit risk management, asset – liability management, the design of systems, procedures, reports etc which enable senior management and directors to assimilate and understand the issues involved and positions taken by bank operatives is an important and complex governance issue.

The BIS has recently released a paper on the framework for the evaluation of internal control systems (BIS, 1998) which identified five categories of control breakdowns typically seen in problem bank cases:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank.
- Inadequate assessment of the risk of certain banking activities, whether on- or off-balance sheet.
- The absence or failure of key control activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance.
- Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems.
- Inadequate or ineffective audit programs and other monitoring activities.

Recent Australian and international experience illustrates the difficulties involved¹². At the extreme level are the cases of financial disasters arising from operatives taking

¹² Problems which arose in the Australian financial markets during the 1980s included: banks (State Bank of Victoria, State Bank of South Australia, and large loan write offs by most banks); building

unauthorized positions or from institutions being unaware of the scale of risk taking involved in certain transactions. Likewise, large scale loan losses occurring in the 1980s reflect inadequate control and loan assessment mechanisms, resulting in surprises to senior management and regulators.

The search for appropriate internal structures suitable for modern large scale financial firms is ongoing. All Australian banks have undertaken significant, and in some cases frequent, organizational restructuring in the search for a suitable framework. Reorganizations based variously along geographical lines, product lines, customer lines have been common. As financial firms have spread across different types of activities, problems of blending different cultures have become important.

Within financial institutions, a key development has been the search for performance measurement techniques which enable better alignment of sub unit goals with those of the organization overall. Three major components of this process can be identified.

First, there has been the continuing development of internal transfer pricing arrangements (see Kimball, 1997) for an overview). Funds transfer pricing systems, which involve business units offsetting customer transactions with a central pool, provide the ability for business units to specialize and allow for more efficient pricing and measurement of profit. Such systems are also integral to the second major development, that of the centralisation of risk management activities. Through the transferring of certain risks through the funds transfer pricing system, risk management can be specialised and advanced risk management techniques adopted¹³. The third development is that of performance measurement, involving the comparison of returns achieved after adjustment for risk taken on, and requiring development of capital allocation techniques¹⁴.

Kimball (1998) provides a good overview of these issues from the perspective of banks. He notes the problems which can arise from use of techniques for measuring

societies (Pyramid Building Society); credit unions (WA Teachers); friendly societies (OST); life offices (Occidental and Regal); unlisted mortgage trusts (Estate Mortgage); unlisted property trusts; and merchant banks (Rothwells).

¹³ Example of systems available are JP Morgan's *Risk Metrics* (for management of market risk) and *Credit Metrics* (for management of credit risk).

business unit performance, such as EVA, when activities are interrelated - such that the level of activity in one area affects earnings in another. Such “spillovers” can occur on the cost side via use of common resources (necessitating use of some cost allocation technique such as Activity Based Costing) or via customer demand effects – which can be particularly important when relationships matter. Kimball also discusses some of the potential problems which arise in attempting to link incentive compensation schemes to performance within subunits, where multiple agents are involved. (A more general discussion of how incentive compensation schemes linked to EVA measures may assist in offsetting owner – manager agency problems can be found in Rogerson, 1997).

6. The Role of Financial Firms in Corporate Governance

By virtue of their role as providers or arrangers of finance, financial firms and markets have an important role to play in the corporate governance of business enterprises.

One major area of concern has been the question of how alternative financial system designs contribute to corporate governance. The comparison made here is typically between “bank based” systems such as those in Germany and Japan, and “capital market based” systems such as that of the USA. Short and Keasey (1997) describe these as a “closed relationship system” versus a “public arms length system”. Differing time horizons, interrelationships between financier and fund seeker, different types of finance and monitoring incentives arising therefrom are all relevant.

It may be argued that the “public arms length system” faces a severe case of the “free rider” problem in regard to monitoring activities. Even where individual stakeholders expend resources on monitoring, such stock market based systems provide deep liquidity and therefore facilitate action by *exit*. In contrast, action by *voice* has adverse immediate wealth consequences for the stakeholder if done publicly whereas the ability to exert influence privately is problematic. In contrast, in a closed relationship system, the individual stakeholder has an incentive (by virtue of a significant stake) and an ability (by virtue of the significant financing role) to exert

¹⁴ Among approaches adopted by Australian banks are those of *EVA* (Economic Value Added) and *RAROC* (risk adjusted return on capital). Kimball (1998) provides a useful discussion of problems involved in capital allocation within financial institutions.

influence by *voice* rather than *exit*. However, the different objectives of the stakeholders in the two systems, reflecting different payoff structures associated with the form of financing, may affect the type of influence exerted¹⁵.

In Australia, there has been a significant shift from intermediary based financing to funds management and direct financing, and the impact of that on corporate governance warrants attention. One concern has been the limited involvement of fund managers in corporate governance issues, an issue recognised by the institutions themselves. In particular, where corporate equity ownership is increasingly concentrated in the hands of a relatively small number of large fund managers, the solution to the free rider problem involved in monitoring and governance needs to be addressed through cooperative action. Two reasons prompt such a response¹⁶. First, given the increased relative size of fund managers and the size of their stake in individual companies, the option of *exit* is limited by market illiquidity. Second, and partly as a consequence, the increasing tendency for fund managers to adopt index tracking strategies means that they must either be willing to accept poor returns, if that is the consequence of governance arrangements in place, or take action via *voice*.

Industry associations such as *AIMA* (Australian Investment Managers Association) have focused on this, and released publications addressing the role of fund managers in corporate governance. To date, however, with a few exceptions, fund managers have played a muted role in corporate governance in Australia. Carleton *et al* (1998) provide evidence of the ability of a major US fund manager to exert an influence on corporate governance practices through private communication with target companies.

Apart from the free rider issue, several problems arise in reliance upon fund managers as guardians of corporate governance. First, most large fund managers are parts of diversified financial services firms, which may have significant other involvement with companies in which the fund manager has a stake, or with their competitors. In these circumstances, a need for “Chinese walls” within the financial services firm may be important, and raises questions about how the organisational structure and

¹⁵ An important issue arising from this difference concerns the question of whether the cost of capital may vary between countries in response to alternative governance mechanisms.

¹⁶ See Carleton *et al* (1998) for further elaboration.

governance of the financial services firm can ensure this. Even in the absence of that complication, fund manager nominees on company boards face an awkward task of liaising with the fund manager to ascertain interests and preferences without conveying inside information about the company to the fund manager.

Second, the issue arises of how fund managers can be aware of the governance preferences of their investors, who are the ultimate stakeholders in the companies under consideration. Indeed, a major issue in the Australian market is the divorce between beneficial ownership and control of voting rights. Superannuation funds who control over 25 per cent of funds invested in the ASX generally cede voting rights to the fund managers they employ. Monitoring responsibilities and governance rights are thus two steps removed from the ultimate owners or beneficiaries.

Third, a fundamental problem emerges from the governance issues associated with fund managers themselves. Where fund manager rewards are linked to such observable variables as size of funds under management, and where (because of informational deficiencies) investor allocation of funds is responsive to imperfect measures of manager performance, managers have incentives to “game” their performance. This can involve adjusting portfolio risk to consolidate or provide a significant chance of improvement in their position in “league tables”, as well as a focus on *exit* rather than *voice*. The issue which arises concerns the type of contract design (between fund managers and investors) which might give fund managers the incentive to play a role in governance consistent with the dual characteristic of equity as an investment vehicle and a control mechanism.

7. Conclusion

This paper has argued that financial firms and markets play a fundamental role in the corporate governance processes in the economy. Certain aspects of that role, particularly the role of institutional investors, the merits of a “closed relationship” versus a “public arm’s length” system, and the role of financial institutions as delegated monitors, have been widely discussed in the literature. Likewise, there has been substantial analysis of the agency problems involved in organisational structure of financial firms. However, there has been little attempt in the literature to integrate

these factors, and analyse the implications of the sequence of corporate governance issues involving governance *of, within, and by* financial firms.

This issue is of particular significance for the design and regulation of financial systems and, it is argued, has received little attention in the financial reform process. Most of the discussion of financial reform has concentrated on issues involved in the mechanics of financing, and has downplayed the inherent dual role in financing activities of facilitating financial flows *and* creating stakeholder relationships. Modern financial markets have created further wedges in the gap between ownership and control and their role in governance processes warrants greater attention in financial reform processes.

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