IS TIME TO IMPLEMENT A COMPREHENSIVE CORPORATE GOVERNANCE FRAMEWORK FOR BANKS IN UNITED KINGDOM?

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ABSTRACT

Corporate governance is part and parcel of banking business activities. The issue of governance can be traced back to the birth of the corporation and many corporate governance guidelines have been introduced to minimize the problems. Among the countries who have introduced corporate governance codes, United Kingdom is the first and earliest country which introduces the corporate governance code and it subsequently improves the code. However, when the UK history of governance issues are examined, the existing code is not able to solve the contemporary governance problems. Among the issues, this paper highlights the existing code is not really comprehensive enough to cover the responsibility of board of directors towards the risk management, transparency of information, competency of directors and role of institutional ownership and reconciliation of stakeholders' interests. Therefore, this paper suggests there is a need for a more comprehensive corporate governance code in UK.

Keywords: corporate governance, board of directors, United Kingdom, agency conflict and issues

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1. INTRODUCTION

Any corporation including banks needs a system to administer its operation towards achieving its aims and targets. This highlights the important role of corporate governance to ensure that the management and control of organization are on the right track. In addition, good corporate culture, performing integrity and accountability are some of the key elements to guarantee the positive impact of corporate governance in any corporation.

The 21st century now seems to stress more on corporate governance given the substantial financial crisis happen worldwide and became worsen in the year 2012. Therefore, government and private bodies put more focus on reviewing the conduct of corporate governance with the aim to provide means to secure the operation of organization including banks and other financial institution.

Over the past history, UK is the first country to break the new ground for establishing corporate governance code with the start of Cadbury Report back in the year 1992. Throughout the century, the code has been reviewed and renewed to enhance the objectives and ensure the code is suitable to be applied in all types of organization either financial or non-financial business. According to Hassan and Salleh (2002), various parties either indirect or directly related to the UK Corporation such as the company directors, institutional investors and the government have come together to resolve the problems of corporate failures in the UK, including the scandals in banks which have affected economic and social condition in the country.

With this premise and background, this research will have a look at the practice of corporate governance in the United Kingdom specifically on the current problems, challenges and obstacles of its implementation in banking sector. The report has four sections. Second section delves into the overview concept of corporate governance and a bit of historical aspects of corporate governance effort in the UK. Section Three explores corporate governance issues being circulated and debated in UKThe last section concludes.

2. CORPORATE GOVERNANCE AND ITS HISTORY IN THE UNITED KINGDOM (UK)

2.1 Definition

Macey, J. R. and M. O'Hara (2003) has acknowledged corporation as a "complex set of explicit and implicit contracts" which can be understood as a form of contracts between various claimants in the organization to achieve certain objectives. This is in line with the American definition of corporate governance that it is an "implicit terms of contract between shareholders and the firm i.e. the claimants to agree on the managers or director's duty to maximize shareholders' value in the firm" (Macey& O'Hara, 2003). Similarly, the Organization for Economic Co-operation and Development (OECD) principles has agreed to the above definition by defining corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders" (Basel Committee on Banking Supervision, 2010).

Apart from defining corporate governance in terms of the relationship between management, shareholders and other stakeholders, the researchers have analyzed another meaning by defining corporate governance in terms of accountability and effectiveness. The second corporate governance code in the United Kingdom i.e. the Greenbury Report (1995) and Hampel Report (1998) have put the way forward for corporate governance in terms of strengthening accountability to enhance performance and business prosperity despite of statutory control in the corporation itself. This focus of corporate governance has also been recognized by Hassan, V., B. Shanmugam, et al. (2005). According to them,the corporate governance prompts the organization to exercise accountability to the public or other stakeholders who might get the impact and benefited from the operations of the organizations.

2.2History and Development of Corporate Governance in the United Kingdom

Throughout the history, the UK has become the pioneer in establishing the corporate governance code and practice. This issue of corporate governance code is due to the outburst of corporate scandals in Polly Peck Textile Company[1] and the Maxwell scandals in the United Kingdom back in the late 1980s and early 1990s (Maie, 2005). Consequently, in the 1992, the UK government has established the first corporate governance code i.e. the Cadbury Report, which forms a system as "how companies are directed and control" in terms of maximizingshareholder's value by the directors and management (Cadbury Report, 1992). In addition, Cadbury Report (1992) focuses more on the internal control of the company including the correlation between chairman, chief executive officer and the reporting system (Mizuno &Tabner, 2009). Then, the Greenbury Report being issued in the year 1995 has stressed on the shareholder's perspective and proposed the remuneration of directors (Mizuno &Tabner, 2009).

[1] Bates, Stephen. (2010). How Polly Peck went from hero to villain in the City, *The Guardian*.

On the other hand, in the year 1998, the UK government has realized on the existence of other stakeholders which also have a great impact towards the operation of the company. Thus, Hampel Report has been issued to highlight on the interest of other stakeholders not only the shareholders. Hampel Report emphasized on accountability and huge transparency in the board structure and operation (Weir & Laing, 2001).

After reviewing the recommendations being provided in those previous corporate governance reports, the UK government has then established the Combined Code in 1998 and it has been revised in 2003 and 2009. The major point being outlined by the Financial Reporting Council in the Combined Code is about the "comply and explain" principles in which companies are put under obligation to comply to the provision of corporate governance code and when do not comply to the code, they need to provide explanation in the Annual Report about the reasons of non-compliance (Pass, 2008). As "comply and explain" becomes the outstanding trademark of corporate governance in the UK, more revision to the code has been done to address the current financial crisis happening worldwide which will obviously affect corporate governance systems in companies (Financial Reporting Council, 2010).

2.3 Overview of Corporate Governance in Banks

OECD (2004) has outlined that corporate governance as an important agenda because it has an impact on the growth, employment and economic development of a country We focus on the failure of the corporate governance of the banks because their conduct and behavior can have the negative impacts on the country economy. Overall in the financial market, banks play the role as financial intermediaries between lender and savers (depositors) (Mishkin& Eakins, 2009). This responsibility of banks towards protecting depositors‟ funds has made corporate governance important for banking organizations to uphold public trust towards the banking system and to maintain the stakeholders‟ confidence including the shareholders and investors (Basel Committee on Banking Supervision, 2005). Therefore, any failure and fraud happened in the banks or other financial institutions will destroy these trust and confidence which might lead to the collapse of the banking institutions, for instance,the failure of Barings Bank in 1995 and Northern Rock in 2007.

3. ISSUES OF CORPORATE GOVERNANCE IN THE UK BANKING SECTOR

3.1 UK Legal and Regulatory Framework

3.1.1 English Company Law versus Corporate Governance Code

In the current economic and financial crisis, all countries have tightened and revised their legal and regulatory frameworks to address and prevent financial scandals happened in any organization. UK government has revised their corporate governance and company laws to attend the recent financial and corporate scandals which not only happen in the UK but scandals happen in the United States have also provided a great impact in the UK corporate governance (Alexander, 2004). As a result, the Combined Code of Corporate Governance being established in 1998 has been revised in 2003 together with the 2003 Higgs Review to take into account the role of non-executive directors and to split the responsibility of the Chief Executive Officer and board chairman. This is to ensure that the non-executive directors will be independent to complete their responsibility in the company's corporate governance structures and decision-making processes (Pass, 2008).

According to Alexander (2004), banks are regarded as corporation in itself. Therefore, how banks are governed will directly affect the valuation of banks, cost of capital and bank's performance. That is why in the United Kingdom, the regulatory board has currently exercise external standards to protect banks which are exposed to the systematic risk and depositor protection. Moreover, the traditional Cadbury Report of corporate governance model has stated that ultimate aim for directors is to maximize shareholder wealth. Meanwhile, the UK English Company Law has outlined those directors' responsibilities towards the company, not towards the individual shareholders (Alexander, 2004). As a consequence, this difference between the UK corporate governance codes and the English Company Law might lead to difficulties for banks and other financial institutions in terms of corporate governance implementation as they are bound to both regulatory frameworks.

3.1.2 Anti-Money Laundering Rules

On the other hand, the corporate governance challenges have been affected by the Anti-Money Laundering Rules in the UK. In this case, the Financial Services Authority (FSA) has imposed the Financial Services and Markets Act (FSMA) to apply the statutory objectives towards reducing financial crime, impose due diligence and proper reporting requirement for financial institutions. Any money laundering cases happened in banks and other financial institutionshave anegative impact towards corporate governance practice because it evidences that the management is not playing a clean role to run the business. Although the government has imposed anti-money laundering rules on corporation, the rules have not helped to prevent money laundering action happened in the organization. As an example, Bank of Credit and Commercial International (BCCI) in the UK has been caught in money laundering case back in 1980s[2]. BCCI has involved in massive money laundering in major American banks. This money laundering case is related to the issue in corporate governance because the case has been conducted by the bank's officer who really has the objective to commit fraud by keeping the banks fundamentally free from government controls and involve in illegal banking activities.

3.2 Management of Banks and Other Financial Institutions

Another issue that can lead to the dispute in corporate governance is in terms of the management of the banks itself. This issue can be argued with regards to the competency of the non-executive directors and the role of institutional investors Revised Combined Code has focused on board behaviors by looking at the roles of the chairman and non-executive directors (Financial Reporting Council, 2009). According to the Combined Code established firstly in 2003, they have set that the aims and objectives of the company are not only to maximize shareholders' value but also to ensure obligation to other stakeholders as well (Financial Reporting Council, 2003). Therefore, the non-executive directors have been appointed by the board members to develop a strategy in order to achieve this objective and regularly report the management performance in the meetings. It is the responsibility of the non- executive directors to meet the "comply and explain" principle required by the Combined Code of Corporate Governance.

3.2.1 Competency of Non-Executive Directors

There are some challenges to meet the corporate governance requirement of the Combined Code. These are regards to the capability and proficiency of the non-executive directors who manage the company including banks and other financial institutions. According to Walker (2009), UK banks particularly the UK-listed banks have grown much bigger in its board size in order to sustain the increasing demand from customers and depositors in the banking sector. Therefore, with this enhancement of board size, banks and other financial institutions need to be supported

[2] Information on the collapse of Bank of Credit and Commercial International (BCCI) is available online in BBC News at http://news.bbc.co.uk/2/hi/business/3383461.stm

and managed by the most eligible and qualified non-executive directors. This does not exclude the state of independence of the board in which half of the board needs to be independent (Walker, 2009).

As banks and other financial institutions are exposed to more risk, for instanceliquidity risk. It is also necessary to protect the depositors, the experienced non-executive directors. Their main responsibility is to set an effective strategy to mitigate the risk. Only excellent directors and supportive team members should run the banking business to be efficient Tomasic (2010) raises his concern that many non-executive directors and board members have lacked the bank-related experience to run the business activities in the banks. He finds that the chairman of few financial institutions do not come from the banking background for example, the chairman in Northern Rock is a zoologist and the chairman in Royal Bank of Scotland is a mathematician (Tomasic, 2010). His view can be agreed because in a highly demanded banking business, the financial institutions need someone, especially in the top management level, who has enough banking experience to run the business and to deal with any problems in the banks. Therefore, a non-competency has led to a terrible strategy being implemented to run the banking business. In researchers' point of view, this is not to provide negative judgments towards the person who do not have banking experience as incapable to manage the banks but in reality, those who have expertise in banking sector tend to perform better compared to the one who does not.

The importance of experience and expertise in banking sector have been proved by the subprime mortgage crisis happened in Northern Rock in the UK. As said above, the chairman of Northern Rock is a zoologist, thus he might not have enough experience to establish banking business strategies. The existence of incapable non-executive directors in Northern Rock has led to the bank's running a high-risk and hasty business model (Tomasic, 2008). In this case, Northern Rock has been involved in the securitization process by giving out mortgages to customers and then re-selling it out to the international money market. This business model has been practiced by Northern Rock which depends heavily on the securitized mortgage and wholesale funds (Tomasic, 2008). Up to a certain stage and given the 2007 financial crisis, there has been a huge drop in the demand for the securitized mortgage from customers. Therefore, Northern Rock has caught into difficulties to repay the loans from the money market and put the institutions into liquidity problems. Although it does not lead to insolvency and collapse of Northern Rock, but the scandals happen in the bank have shown the true importance of having a competent non-executive as well as the executive directors on board.

3.2.2 Role of Institutional Investors

With regards to the role of institutional investors, the House of Commons Treasury Committee (2009) has founded, that the breakdown in corporate governance is caused by the failure of the institutional investors to analyze the performance and decision making being made by directors in the banks which they have invested. Based on the review done by David Walker towards corporate governance in banks, he discoversthat the focus of behavior shifted from the owner to investor (Walker, 2009). Also, Mizuno and Tabner (2009) regarded institutional investors as an important element of corporate governance in which their responsibility is to monitor managers" performance and to satisfy the interest of shareholders.

However, poor institutional shareholders and investors may lead to the collapse of bank's operation. For instance, in 1995, Barings Bank based in London has fall down because of the massive trading loss in derivatives by one of its employees, Nick Leeson who is based in Singapore. One question that has come into researcher mind is that how can this so called illegal trading activity by individuals were not detected by the banks earlier. This demonstrates poor internal control and the failure of the institution to detect the unlawful activity within the bank. It shows that corporate governance is weak. According to Drummond (2002), directors and shareholders might not be able to detect the fraud in Barings Bank because the derivatives trading activity has produced a 3 years fruitful profits to the bank. That is why they could not think about the deceit going around in the bank until it was discovered in 1995 (Drummond, 2002). Tomasic (2010) names this as "problem of gatekeeper failure" where both internal and external parties to the corporation could not even detect the wrongdoings in the institution. Therefore, the role of boards, non-executive directors, auditors and others can be questioned.

3.3 Market and Economic Situations

Financial and economic crisis are currently happening in most of the developed countries including the UK. It has been reported recently that more than 1 million young people are unemployed in the UK which will lead to even worst economic crisis in the country (Hope, 2011) and UK could go into recession in later years (Sparkes&Trotman, 2011). Even at the existence of all legal and regulatory frameworks provided in the UK, the framework is not able to safeguard corporate governance practice as the financial world is currently being controlled by the subprime market in the US (Kirkpatrick, 2009). Therefore, any financial crisis happened in the US from the Great Depression in 1920s till now provides the impact on corporate governance in banks and other financial institutions in the UK. This is because most countries currency has been pegged to US Dollar of exchange. This credit crunch happened worldwide has proved to affect the UK economy, for instance, the downturn of Northern Rock in the year 2007 which has affected its mortgage lending business (Tomasic, 2008).

However, interesting argument being put forward by Hogan (1997) that no evidence can be proved to show that market conditions have affected corporate governance in banks and other financial institutions. For instance, Hogan mentioned in his article that, "derivatives financial instruments have not provided an impact towards the collapse of Barings Bank". There is nothing wrong with the use of that type of instruments in trading activities performed by Nick Leeson. According to Hogan (1997), what contributed to the collapse ofBarings Bank is the "unauthorized and concealed trading activities" being done within the bank (Hogan, 1997).

3.4 Issue of Ownership and Control

The issue of ownership in organization and corporation has long well been debated, especially in the corporate governance aspects. Shareholders have been determined to become the owners of the firm, thus most objectives and aims of the firms are in the area of maximizing their wealth. That is why the first corporate governance codes in the UK i.e. the Cadbury Report is also addressing this objective to satisfy the interest of shareholders (Cadbury Report, 1992).

According to Alexander (2006), "banks are special as it plays an integral role to the economy by providing financing for commercial enterprises, access to payment systems and giving out other financial services to enhance the economy as a whole". On the other hand, it is agreed that stakeholders such as customers, shareholders and employees are too-dependent on the performance of the banking industry (Alexander, 2006). That is why any issues and challenge regarding banks will affect their trust and confidence to the banking sector. In other words, it could be assumed that the stakeholders indirectly own the bank as they all have got interests towards the performance of banks and how much profit the banks will be making in the consecutive years to predict their survival. As an example, the decline in mortgage lending business in Northern Rock has wiped out the confidence of customers towards the bank as they are worried of not getting their money back (Peston, 2007).

The issue ownership above leads to the control issue in banks. This is called the principal-agent problems which occur when the owners are not the same person as the one who manage the firm. In this case, the problems usually arise when there is a lack of information and insufficient incentives between the principal and the agent. According to Alexander (2006), there are some difficulties for a bank to scrutinize the behavior of the borrower and also for the bank owner to monitor the level of effort being contributed by the employees of the banks. This problem might happen because of the divergent interests among the aims of owners and stakeholders. In addition, it can happen because how far the management is committed towards achieving those objectives. As a consequence, corporate governance of banks will be put into threat as the misbehavior of the agents who manage the banks. Finally, it will lead to the possibility of banks being fall into demise. Therefore, banks regulation and regular review towards the corporate governance practice in banks and other financial institutions are essential in order to ensure that they comply with the principles. The latest effort being done by Sir David Walker in late 2009 ~~to~~ reviews the corporate governance in banks and provides a guideline and recommendation to enhance governance practice in the institution given the latest announcement of credit crunch which will happen in the UK (Aldrick, Economics Editor, &Kirkup, 2011).

4. SUMMARY AND CONCLUSION

After studying the implementation of corporate governance in the UK together with the challenges of its application in banking sector, researchers realizethat the system needs a lot of understanding and support from all anglesfrom shareholders, directors, employees, investors, other stakeholders who will feel the effect of the system. As mentioned previously, corporate governance is about a system and how people are accountable to comply with the system in its form.

This research confirms that UK has long become the leader to begin with its first corporate governance code back in the year 1992. Till now, most of the countries have been implementing and improving the corporate governance code in running their business, specifically the banking activities. In terms of the legal and regulatory framework, researcher can say that it is good if it can harmonize the compliance to the corporate governance code together with the banking regulation.

With regards to the issue of management in banks itself, those who have the authority to appoint the directors must confirm his or her true qualification before joining the corporation as their behavior might lead to the collapse of banks as what has happened in Northern Rock. On the other hand, directors, institutional investors and the shareholders need to work together either giving out any form of direct or indirect help to the management of the banks. This is to ensure that both parties understand each other's responsibility and not just one side of the party who need to work hard to achieve profitable performance for the financial institutions. This might help to reduce the problems of principal-agent problems occur in banks.

Having look at the current market and economic situation in the UK, the researchers can feel that the people over there might have put under a stressful condition such as high unemployment, forecast recession and expected credit crunch which will happen again in the near future. The latest news by BBC Network stating that Sir Mervyn King, the Bank of England Governor have warned a threshold of second credit crunch which will happen in the UK (Aldrick et al., 2011). Given this warning, researchers believe that banks and other financial institutions need to scrutinize their corporate governance practice to accommodate and prevent this expected financial crisis. This is to ensure that no one in the banks will perform any illegal activities or misbehavior that will affect the future success of the banks as what has happened in Barings Bank back in 1995.

Finally, to conclude, the system of corporate governance is needed to ensure that people have a proper guideline to run activities in the corporation or organization. But again, understanding and full co-operation from various parties are essential to guarantee its effective implementation either in banks and financial institutions, the organization or the government of the country as a whole. Therefore, this paper proposes to implement a comprehensive corporate governance framework in UK.

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